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SUBCHAPTER A—INCOME TAX (CONTINUED)

PART 1—INCOME TAXES (CONTINUED)

NORMAL TAXES AND SURTAXES (CONTINUED)

GAIN OR LOSS ON DISPOSITION OF PROPERTY

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Section 1.1092(b)–6 also issued under 26 U.S.C. 1092(b)(1).
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Section 1.1092(d)–1 also issued under 26 U.S.C. 1092(b)(1).
Section 1.1092(d)–2 also issued under 26 U.S.C. 1092(d)(3)(B).
Section 1.1202–2 is also issued under 26 U.S.C. 1202(k).
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Section 1.1254–3 also issued under 26 U.S.C. 1254(b).
Section 1.1254–4 also issued under 26 U.S.C. 1254(b).
Section 1.1254–5 also issued under 26 U.S.C. 1254(b).
Section 1.1254–6 also issued under 26 U.S.C. 1254(b).
Section 1.1271–1 also issued under 26 U.S.C. 1275(d).
Section 1.1272–1 also issued under 26 U.S.C. 1275(d).
Section 1.1272–2 also issued under 26 U.S.C. 1275(d).
Section 1.1272–3 also issued under 26 U.S.C. 1275(d).
Section 1.1273–1 also issued under 26 U.S.C. 1275(d).
Section 1.1273–2 also issued under 26 U.S.C. 1275(d).
Section 1.1274–1 also issued under 26 U.S.C. 1275(d).
Section 1.1274–2 also issued under 26 U.S.C. 1275(d).
Section 1.1274–3 also issued under 26 U.S.C. 1275(d).
Section 1.1274–4 also issued under 26 U.S.C. 1275(d).
Section 1.1274–5 also issued under 26 U.S.C. 1275(d).
Section 1.1274A–1 also issued under 26 U.S.C. 1274A(e) and 26 U.S.C. 1275(d).
Section 1.1275–1 also issued under 26 U.S.C. 1275(d).
Section 1.1275–2 also issued under 26 U.S.C. 1275(d).
Section 1.1275–3 also issued under 26 U.S.C. 1275(d).
Section 1.1275–4 also issued under 26 U.S.C. 1275(d).
Section 1.1275–5 also issued under 26 U.S.C. 1275(d).
Section 1.1275–6 also issued under 26 U.S.C. 1275(d).
Section 1.1275–7 also issued under 26 U.S.C. 1275(d).
Section 1.1286–1 also issued under 26 U.S.C. 1275(D) and 1286(f).
Section 1.1286–2 also issued under 26 U.S.C. 1286(f).
Section 1.1287–1 also issued under 26 U.S.C. 165 (j)(3).
Section 1.1291–1 also issued under 26 U.S.C. 1291.
Section 1.1291–1 also issued under 26 U.S.C. 1298(a) and (g).
Section 1.1291–9, also issued under 26 U.S.C. 1298(a) and (g).
Section 1.1298–1 also issued under 26 U.S.C. 1298(f).

Section 1.1291–9 also issued under 26 U.S.C. 1291(d)(2).
Section 1.1291–10 also issued under 26 U.S.C. 1291(d)(2).
Section 1.1293–1 also issued under 26 U.S.C. 1293.
Section 1.1294–1T also issued under 26 U.S.C. 1294.
Section 1.1295–1 also issued under 26 U.S.C. 1295.
Section 1.1295–3 also issued under 26 U.S.C. 1295.
Section 1.1296–1 also issued under 26 U.S.C. 1296(g) and 26 U.S.C. 1298(f).
Section 1.1296(e)–1 also issued under 26 U.S.C. 1296(e).
Section 1.1297–1 also issued under 26 U.S.C. 1298(g).
Section 1.1297–2 also issued under 26 U.S.C. 1298(g).
Section 1.1297–3T also issued under 26 U.S.C. 1297(b)(1).
Section 1.1297–4 also issued under 26 U.S.C. 1297(b)(2)(B) and 1298(g).
Section 1.1297–5 also issued under 26 U.S.C. 1297(b)(2)(B) and 1298(g).
Section 1.1297–6 also issued under 26 U.S.C. 1297(b)(2)(B) and 1298(g).
Section 1.1298–1T also issued under 26 U.S.C. 1298(f) and (g).

Section 1.1298–2 also issued under 26 U.S.C. 1298(b)(3) and (g).

Section 1.1298–4 also issued under 26 U.S.C. 1298(g).

Section 1.1301–1 also issued under 26 U.S.C. 1301(c).

Section 1.1301–1T also issued under 26 U.S.C. 1301(c).

Section 1.1361–1(j) (6), (10) and (11) also issued under 26 U.S.C. 1361(d)(2)(B)(iii).

Section 1.1361–1(l) also issued under 26 U.S.C. 1361(c)(5)(C).

Sections 1.1362–1, 1.1362–2, 1.1362–3, 1.1362–4, 1.1362–5, 1.1362–6, 1.1362–7, and 1.1363–1 also issued under 26 U.S.C. 1377.

Section 1.1363–2 also issued under 26 U.S.C. 337(d).

Section 1.1368–1(f) and (g) also issued under 26 U.S.C. 1377(c).

Section 1.1368–2(b) also issued under 26 U.S.C. 1368(c).

Section 1.1374–1 also issued under 26 U.S.C. 1374(e) and 337(d).

Section 1.1374–2 also issued under 26 U.S.C. 1374(e) and 337(d).

Section 1.1374–3 also issued under 26 U.S.C. 1374(e) and 337(d).

Section 1.1374–4 also issued under 26 U.S.C. 1374(e) and 337(d).

Section 1.1374–5 also issued under 26 U.S.C. 1374(e) and 337(d).

Section 1.1374–6 also issued under 26 U.S.C. 1374(e) and 337(d).

Section 1.1374–7 also issued under 26 U.S.C. 1374(e) and 337(d).

Section 1.1374–8 also issued under 26 U.S.C. 337(d) and 1374(e).

Section 1.1374–8 also issued under 26 U.S.C. 1374(e) and 337(d).

Section 1.1374–8T also issued under 26 U.S.C. 337(d) and 1374(e).

Section 1.1374–9 also issued under 26 U.S.C. 1374(e) and 337(d).

Section 1.1374–10 also issued under 26 U.S.C. 337(d) and 1374(e).

Section 1.1374–10 also issued under 26 U.S.C. 1374(e) and 337(d).

Section 1.1374–10T also issued under 26 U.S.C. 337(d) and 1374(e).

Section 1.1377–1 also issued under 26 U.S.C. 1377(a)(2) and (c).

Section 1.1394–1 also issued under 26 U.S.C. 1397D.

Section 1.1396–1 also issued under 26 U.S.C. 1397D.

Section 1.1397E–1 also issued under 26 U.S.C. 1397E.

Section 1.1400Z2(a)–1 also issued under 26 U.S.C. 1400Z–2(e)(4).

Section 1.1400Z2(b)–1 also issued under 26 U.S.C. 1400Z–2(e)(4).

Section 1.1400Z2(c)–1 also issued under 26 U.S.C. 1400Z–2(e)(4).

Section 1.1400Z2(d)–1 also issued under 26 U.S.C. 1400Z–2(e)(4).

Section 1.1400Z2(d)–2 also issued under 26 U.S.C. 1400Z–2(e)(4).

Section 1.1400Z2(f)–1 also issued under 26 U.S.C. 1400Z–2(e)(4).

EDITORIAL NOTE: At 72 FR 51705, Sept. 11, 2007, the authority citation was amended by removing §1.1060–T; however, the amendment could not be incorporated due to inaccurate amendatory instruction.

SOURCE: T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, unless otherwise noted.

GAIN OR LOSS ON DISPOSITION OF PROPERTY

DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS

§ 1.1001–1 Computation of gain or loss.

(a) *General rule.* Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001 (a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations thereunder (i.e., the cost or other basis adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder. Section

1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010).

(b) *Real estate taxes as amounts received.* (1) Section 1001(b) and section 1012 state rules applicable in making an adjustment upon a sale of real property with respect to the real property taxes apportioned between seller and purchaser under section 164(d). Thus, if the seller pays (or agrees to pay) real property taxes attributable to the real property tax year in which the sale occurs, he shall not take into account, in determining the amount realized from the sale under section 1001(b), any amount received as reimbursement for taxes which are treated under section 164(d) as imposed upon the purchaser. Similarly, in computing the cost of the property under section 1012, the purchaser shall not take into account any amount paid to the seller as reimbursement for real property taxes which are treated under section 164(d) as imposed upon the purchaser. These rules apply whether or not the contract of sale calls for the purchaser to reimburse the seller for such real property taxes paid or to be paid by the seller.

(2) On the other hand, if the purchaser pays (or is to pay) an amount representing real property taxes which are treated under section 164(d) as imposed upon the seller, that amount shall be taken into account both in determining the amount realized from the sale under section 1001(b) and in computing the cost of the property under section 1012. It is immaterial whether or not the contract of sale specifies that the sale price has been reduced by, or is in any way intended to reflect, the taxes allocable to the seller. See also paragraph (b) of § 1.1012–1.

(3) Subparagraph (1) of this paragraph shall not apply to a seller who, in a taxable year prior to the taxable year of sale, pays an amount representing real property taxes which are treated under section 164(d) as imposed on the purchaser, if such seller has elected to capitalize such amount in accordance with section 266 and the regulations thereunder (relating to election to capitalize certain carrying charges and taxes).

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

Example 1. Assume that the contract price on the sale of a parcel of real estate is $50,000 and that real property taxes thereon in the amount of $1,000 for the real property tax year in which occurred the date of sale were previously paid by the seller. Assume further that $750 of the taxes are treated under section 164(d) as imposed upon the purchaser and that he reimburses the seller in that amount in addition to the contract price. The amount realized by the seller is $50,000. Similarly, $50,000 is the purchaser's cost. If, in this example, the purchaser made no payment other than the contract price of $50,000, the amount realized by the seller would be $49,250, since the sales price would be deemed to include $750 paid to the seller in reimbursement for real property taxes imposed upon the purchaser. Similarly, $49,250 would be the purchaser's cost.

Example 2. Assume that the purchaser in example (1), above, paid all of the real property taxes. Assume further that $250 of the taxes are treated under section 164(d) as imposed upon the seller. The amount realized by the seller is $50,250. Similarly, $50,250 is the purchaser's cost, regardless of the taxable year in which the purchaser makes actual payment of the taxes.

Example 3. Assume that the seller described in the first part of example (1), above, paid the real property taxes of $1,000 in the taxable year prior to the taxable year of sale and elected under section 266 to capitalize the $1,000 of taxes. In such a case, the amount realized is $50,750. Moreover, regardless of whether the seller elected to capitalize the real property taxes, the purchaser in that case could elect under section 266 to capitalize the $750 of taxes treated under section 164(d) as imposed upon him, in which case his adjusted basis would be $50,750 (cost of $50,000 plus capitalized taxes of $570).

(c) *Other rules.* (1) Even though property is not sold or otherwise disposed of, gain is realized if the sum of all the amounts received which are required by section 1016 and other applicable provisions of subtitle A of the Code to be applied against the basis of the

property exceeds such basis. Except as otherwise provided in section 301(c)(3)(B) with respect to distributions out of increase in value of property accrued prior to March 1, 1913, such gain is includible in gross income under section 61 as ''income from whatever source derived''. On the other hand, a loss is not ordinarily sustained prior to the sale or other disposition of the property, for the reason that until such sale or other disposition occurs there remains the possibility that the taxpayer may recover or recoup the adjusted basis of the property. Until some identifiable event fixes the actual sustaining of a loss and the amount thereof, it is not taken into account.

(2) The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example: A, an individual on a calendar year basis, purchased certain shares of stock subsequent to February 28, 1913, for $10,000. On January 1, 1954, A's adjusted basis for the stock had been reduced to $1,000 by reason of receipts and distributions described in sections 1016(a)(1) and 1016(a)(4). He received in 1954 a further distribution of $5,000, being a distribution covered by section 1016(a)(4), other than a distribution out of increase of value of property accrued prior to March 1, 1913. This distribution applied against the adjusted basis as required by section 1016(a)(4) exceeds that basis by $4,000. The $4,000 excess is a gain realized by A in 1954 and is includible in gross income in his return for that calendar year. In computing gain from the stock, as in adjusting basis, no distinction is made between items of receipts or distributions described in section 1016. If A sells the stock in 1955 for $5,000, he realizes in 1955 a gain of $5,000, since the adjusted basis of the stock for the purpose of computing gain or loss from the sale is zero.

(d) *Installment sales.* In the case of property sold on the installment plan, special rules for the taxation of the gain are prescribed in section 453.

(e) *Transfers in part a sale and in part a gift.* (1) Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis. For the determination of basis of property in the hands of the transferee, see § 1.1015–4. For the allocation of the adjusted basis of property in the case of a bargain sale to a charitable organization, see § 1.1011–2.

(2) *Examples.* The provisions of subparagraph (1) may be illustrated by the following examples:

Example 1. A transfers property to his son for $60,000. Such property in the hands of A has an adjusted basis of $30,000 (and a fair market value of $90,000). A's gain is $30,000, the excess of $60,000, the amount realized, over the adjusted basis, $30,000. He has made a gift of $30,000, the excess of $90,000, the fair market value, over the amount realized, $60,000.

Example 2. A transfers property to his son for $30,000. Such property in the hands of A has an adjusted basis of $60,000 (and a fair market value of $90,000). A has no gain or loss, and has made a gift of $60,000, the excess of $90,000, the fair market value, over the amount realized, $30,000.

Example 3. A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $30,000 (and a fair market value of $60,000). A has no gain and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

Example 4. A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $90,000 (and a fair market value of $60,000). A has sustained no loss, and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

(f) *Sale or other disposition of a term interest in property*—(1) *General rule.* Except as otherwise provided in paragraph (f)(3) of this section, for purposes of determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in paragraph (f)(2) of this section), a taxpayer shall not take into account that portion of the adjusted basis of such interest that is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010) to the extent that such adjusted basis is a portion of the adjusted uniform basis of the entire property (as defined in § 1.1014–5). Where a term interest in property is transferred to a corporation in connection with a transaction to

which section 351 applies and the adjusted basis of the term interest:

(i) Is determined pursuant to sections 1014, 1015, or 1022; and

(ii) Is also a portion of the adjusted uniform basis of the entire property, a subsequent sale or other disposition of such term interest by the corporation will be subject to the provisions of section 1001(e) and this paragraph (f) to the extent that the basis of the term interest so sold or otherwise disposed of is determined by reference to its basis in the hands of the transferor as provided by section 362(a). See paragraph (f)(2) of this section for rules relating to the characterization of stock received by the transferor of a term interest in property in connection with a transaction to which section 351 applies. That portion of the adjusted uniform basis of the entire property that is assignable to such interest at the time of its sale or other disposition shall be determined under the rules provided in § 1.1014–5. Thus, gain or loss realized from a sale or other disposition of a term interest in property shall be determined by comparing the amount of the proceeds of such sale with that part of the adjusted basis of such interest that is not a portion of the adjusted uniform basis of the entire property.

(2) *Term interest defined.* For purposes of section 1001(e) and this paragraph, a *term interest in property* means—

(i) A life interest in property,

(ii) An interest in property for a term of years, or

(iii) An income interest in a trust.

Generally, subdivisions (i), (ii), and (iii) refer to an interest, present or future, in the income from property or the right to use property which will terminate or fail on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur. Such divisions do not refer to remainder or reversionary interests in the property itself or other interests in the property which will ripen into ownership of the entire property upon termination or failure of a preceding term interest. A *term interest in property* also includes any property received upon a sale or other disposition of a life interest in property, an interest in property for a term of years, or an income interest in a trust by the original holder of such interest, but only to the extent that the adjusted basis of the property received is determined by reference to the adjusted basis of the term interest so transferred.

(3) *Exception.* Paragraph (1) of section 1001(e) and subparagraph (1) of this paragraph shall not apply to a sale or other disposition of a term interest in property as a part of a single transaction in which the entire interest in the property is transferred to a third person or to two or more other persons, including persons who acquire such entire interest as joint tenants, tenants by the entirety, or tenants in common. See § 1.1014–5 for computation of gain or loss upon such a sale or other disposition where the property has been acquired from a decedent or by gift or transfer in trust.

(4) *Illustrations.* For examples illustrating the application of this paragraph, see paragraph (d) of § 1.1014–5.

(g) *Debt instruments issued in exchange for property*—(1) *In general.* If a debt instrument is issued in exchange for property, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1273–2 or § 1.1274–2, whichever is applicable. If, however, the issue price of the debt instrument is determined under section 1273(b)(4), the amount realized attributable to the debt instrument is its stated principal amount reduced by any unstated interest (as determined under section 483).

(2) *Certain debt instruments that provide for contingent payments*—(i) *In general.* Paragraph (g)(1) of this section does not apply to a debt instrument subject to either § 1.483–4 or § 1.1275–4(c) (certain contingent payment debt instruments issued for nonpublicly traded property).

(ii) *Special rule to determine amount realized.* If a debt instrument subject to § 1.1275–4(c) is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1274–2(g), increased by the fair

market value of the contingent payments payable on the debt instrument. If a debt instrument subject to § 1.483–4 is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, the amount realized attributable to the debt instrument is its stated principal amount, reduced by any unstated interest (as determined under section 483), and increased by the fair market value of the contingent payments payable on the debt instrument. This paragraph (g)(2)(ii), however, does not apply to a debt instrument if the fair market value of the contingent payments is not reasonably ascertainable. Only in rare and extraordinary cases will the fair market value of the contingent payments be treated as not reasonably ascertainable.

(3) *Coordination with section 453.* If a debt instrument is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, this paragraph (g) applies rather than § 15a.453–1(d)(2) to determine the taxpayer's amount realized attributable to the debt instrument.

(4) *Effective date.* This paragraph (g) applies to sales or exchanges that occur on or after August 13, 1996.

(h) *Severances of trusts*—(1) *In general.* The severance of a trust (including without limitation a severance that meets the requirements of § 26.2642–6 or of § 26.2654–1(b) of this chapter) is not an exchange of property for other property differing materially either in kind or in extent if—

(i) An applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and

(ii) Any non-pro rata funding of the separate trusts resulting from the severance (including non-pro rata funding as described in § 26.2642–6(d)(4) or § 26.2654–1(b)(1)(ii)(C) of this chapter), whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument.

(2) *Effective/applicability date.* This paragraph (h) applies to severances occurring on or after August 2, 2007. Taxpayers may apply this paragraph (h) to severances occurring on or after August 24, 2004, and before August 2, 2007.

(i) *Effective/applicability date.* Except as provided in paragraphs (g) and (h) of this section, this section applies on and after January 19, 2017. For rules before January 19, 2017, see § 1.1001–1 as contained in 26 CFR part 1 revised as of April 1, 2016.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7142, 36 FR 18950, Sept. 24, 1971; T.D. 7207, 37 FR 20797, Oct. 5, 1972; T.D. 7213, 37 FR 21992, Oct. 18, 1972; T.D. 8517, 59 FR 4807, Feb. 2, 1994; T.D. 8674, 61 FR 30139, June 14, 1996; T.D. 9348, 72 FR 42293, Aug. 2, 2007; T.D. 9729, 80 FR 48250, Aug. 12, 2015; T.D. 9811, 82 FR 6240, Jan. 19, 2017]

§ 1.1001–2 Discharge of liabilities.

(a) *Inclusion in amount realized*—(1) *In general.* Except as provided in paragraph (a) (2) and (3) of this section, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

(2) *Discharge of indebtedness.* The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). For situations where amounts arising from the discharge of indebtedness are not realized and recognized, see section 108 and § 1.61–12(b)(1).

(3) *Liability incurred on acquisition.* In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property.

(4) *Special rules.* For purposes of this section—

(i) The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability;

(ii) The sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability);

(iii) A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject;

(iv) Contributions and distributions of property between a partner and a partnership are not sales or other dispositions of property; and

(v) The liabilities from which a transferor is discharged as a result of the sale or disposition of a partnership interest include the transferor's share of the liabilities of the partnership.

(b) *Effect of fair market value of security*. The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining under paragraph (a) of this section the amount of liabilities from which the taxpayer is discharged or treated as discharged. Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property. However, see paragraph (a)(2) of this section for a rule relating to certain income from discharge of indebtedness.

(c) *Examples*. The provisions of this section may be illustrated by the following examples. In each example assume the taxpayer uses the cash receipts and disbursements method of accounting, makes a return on the basis of the calendar year, and sells or disposes of all property which is security for a given liability.

Example 1. In 1976 A purchases an asset for $10,000. A pays the seller $1,000 in cash and signs a note payable to the seller for $9,000. A is personally liable for repayment with the seller having full recourse in the event of default. In addition, the asset which was purchased is pledged as security. During the years 1976 and 1977, A takes depreciation deductions on the asset in the amount of $3,100. During this same time period A reduces the outstanding principal on the note to $7,600. At the beginning of 1978 A sells the asset. The buyer pays A $1,600 in cash and assumes personal liability for the $7,600 outstanding liability. A becomes secondarily liable for repayment of the liability. A's amount realized is $9,200 ($1,600 + $7,600). Since A's adjusted basis in the asset is $6,900 ($10,000 − $3,100) A realizes a gain of $2,300 ($9,200 − $6,900).

Example 2. Assume the same facts as in example (1) except that A is not personally liable on the $9,000 note given to the seller and in the event of default the seller's only recourse is to the asset. In addition, on the sale of the asset by A, the purchaser takes the asset subject to the liability. Nevertheless, A's amount realized is $9,200 and A's gain realized is $2,300 on the sale.

Example 3. In 1975 L becomes a limited partner in partnership GL. L contributes $10,000 in cash to GL and L's distributive share of partnership income and loss is 10 percent. L is not entitled to receive any guaranteed payments. In 1978 M purchases L's entire interest in partnership GL. At the time of the sale L's adjusted basis in the partnership interest is $20,000. At that time L's proportionate share of liabilities, of which no partner has assumed personal liability, is $15,000. M pays $10,000 in cash for L's interest in the partnership. Under section 752(d) and this section, L's share of partnership liabilities, $15,000, is treated as money received. Accordingly, L's amount realized on the sale of the partnership interest is $25,000 ($10,000 + $15,000). L's gain realized on the sale is $5,000 ($25,000 − $20,000).

Example 4. In 1976 B becomes a limited partner in partnership BG. In 1978 B contributes B's entire interest in BG to a charitable organization described in section 170(c). At the time of the contribution all of the partnership liabilities are liabilities for which neither B nor G has assumed any personal liability and B's proportionate share of which is $9,000. The charitable organization does not pay any cash or other property to B, but takes the partnership interest subject to the $9,000 of liabilities. Assume that the contribution is treated as a bargain sale to a charitable organization and that under section 1011(b) $3,000 is determined to be the portion of B's basis in the partnership interest allocable to the sale. Under section 752(d) and this section, the $9,000 of liabilities is treated by B as money received, thereby making B's amount realized $9,000. B's gain realized is $6,000 ($9,000 − $3,000).

Example 5. In 1975 C, an individual, creates T, an irrevocable trust. Due to certain powers expressly retained by C, T is a ''grantor trust'' for purposes of subpart E of part 1 of subchapter J of the code and therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. In 1978, when the adjusted basis of the partnership interest held by T is $1,200, C renounces the powers previously and expressly retained that initially resulted in T being classified as a grantor trust. Consequently, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. At the time of the renunciation all of P's liabilities are liabilities on which none of the partners have

assumed any personal liability and the proportionate share of which of the interest held by T is $11,000. Since prior to the renunciation C was the owner of the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a ''grantor trust''. However, at the time C renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor C. On the transfer, C's share of partnership liabilities ($11,000) is treated as money received. Accordingly, C's amount realized is $11,000 and C's gain realized is $9,800 ($11,000 − $1,200).

Example 6. In 1977 D purchases an asset for $7,500. D pays the seller $1,500 in cash and signs a note payable to the seller for $6,000. D is not personally liable for repayment but pledges as security the newly purchased asset. In the event of default, the seller's only recourse is to the asset. During the years 1977 and 1978 D takes depreciation deductions on the asset totaling $4,200 thereby reducing D's basis in the asset to $3,300 ($7,500 − $4,200). In 1979 D transfers the asset to a trust which is not a ''grantor trust'' for purposes of subpart E of part 1 of subchapter J of the Code. Therefore D is not treated as the owner of the trust. The trust takes the asset subject to the liability and in addition pays D $750 in cash. Prior to the transfer D had reduced the amount outstanding on the liability to $4,700. D's amount realized on the transfer is $5,450 ($4,700 + $750). Since D's adjusted basis is $3,300, D's gain realized is $2,150 ($5,450 − $3,300).

Example 7. In 1974 E purchases a herd of cattle for breeding purposes. The purchase price is $20,000 consisting of $1,000 cash and a $19,000 note. E is not personally liable for repayment of the liability and the seller's only recourse in the event of default is to the herd of cattle. In 1977 E transfers the herd back to the original seller thereby satisfying the indebtedness pursuant to a provision in the original sales agreement. At the time of the transfer the fair market value of the herd is $15,000 and the remaining principal balance on the note is $19,000. At that time E's adjusted basis in the herd is $16,500 due to a deductible loss incurred when a portion of the herd died as a result of disease. As a result of the indebtedness being satisfied, E's amount realized is $19,000 notwithstanding the fact that the fair market value of the herd was less than $19,000. E's realized gain is $2,500 ($19,000 − $16,500).

Example 8. In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value ($6,000). In addition, F has income from the discharge of indebtedness of $1,500 ($7,500 − $6,000).

[T.D. 7741, 45 FR 81744, Dec. 12, 1980]

§ 1.1001–3 Modifications of debt instruments.

(a) *Scope*—(1) *In general*. This section provides rules for determining whether a modification of the terms of a debt instrument results in an exchange for purposes of § 1.1001–1(a). This section applies to any modification of a debt instrument, regardless of the form of the modification. For example, this section applies to an exchange of a new instrument for an existing debt instrument, or to an amendment of an existing debt instrument. This section also applies to a modification of a debt instrument that the issuer and holder accomplish indirectly through one or more transactions with third parties. This section, however, does not apply to exchanges of debt instruments between holders.

(2) *Qualified tender bonds*. This section does not apply for purposes of determining whether tax-exempt bonds that are qualified tender bonds are reissued for purposes of sections 103 and 141 through 150.

(b) *General rule*. For purposes of § 1.1001–1(a), a significant modification of a debt instrument, within the meaning of this section, results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent. A modification that is not a significant modification is not an exchange for purposes of § 1.1001–1(a). Paragraphs (c) and (d) of this section define the term *modification* and contain examples illustrating the application of the rule. Paragraphs (e) and (f) of this section provide rules for determining when a modification is a significant modification. Paragraph (f) of this section also provides rules for determining whether the modified instrument received in an exchange will be classified as an instrument or property right that is not

debt for federal income tax purposes. Paragraph (g) of this section contains examples illustrating the application of the rules in paragraphs (e) and (f) of this section.

(c) *Modification defined*—(1) *In general*—(i) *Alteration of terms.* A *modification* means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

(ii) *Alterations occurring by operation of the terms of a debt instrument.* Except as provided in paragraph (c)(2) of this section, an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification. An alteration that occurs by operation of the terms may occur automatically (for example, an annual resetting of the interest rate based on the value of an index or a specified increase in the interest rate if the value of the collateral declines from a specified level) or may occur as a result of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument.

(2) *Exceptions.* The alterations described in this paragraph (c)(2) are modifications, even if the alterations occur by operation of the terms of a debt instrument.

(i) *Change in obligor or nature of instrument.* An alteration that results in the substitution of a new obligor, the addition or deletion of a co-obligor, or a change (in whole or in part) in the recourse nature of the instrument (from recourse to nonrecourse or from nonrecourse to recourse) is a modification.

(ii) *Property that is not debt.* An alteration that results in an instrument or property right that is not debt for Federal income tax purposes is a modification unless the alteration occurs pursuant to a holder's option under the terms of the instrument to convert the instrument into equity of the issuer (notwithstanding paragraph (c)(2)(iii) of this section). The rules of paragraph (f)(7) of this section apply to determine whether an alteration or modification results in an instrument or property right that is not debt.

(iii) *Certain alterations resulting from the exercise of an option.* An alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument is a modification unless—

(A) The option is unilateral (as defined in paragraph (c)(3) of this section); and

(B) In the case of an option exercisable by a holder, the exercise of the option does not result in (or, in the case of a variable or contingent payment, is not reasonably expected to result in) a deferral of, or a reduction in, any scheduled payment of interest or principal.

(3) *Unilateral option.* For purposes of this section, an option is unilateral only if, under the terms of an instrument or under applicable law—

(i) There does not exist at the time the option is exercised, or as a result of the exercise, a right of the other party to alter or terminate the instrument or put the instrument to a person who is related (within the meaning of section 267(b) or section 707(b)(1)) to the issuer;

(ii) The exercise of the option does not require the consent or approval of—

(A) The other party;

(B) A person who is related to that party (within the meaning of section 267(b) or section 707(b)(1)), whether or not that person is a party to the instrument; or

(C) A court or arbitrator; and

(iii) The exercise of the option does not require consideration (other than incidental costs and expenses relating to the exercise of the option), unless, on the issue date of the instrument, the consideration is a de minimis amount, a specified amount, or an amount that is based on a formula that uses objective financial information (as defined in §1.446–3(c)(4)(ii)).

(4) *Failure to perform*—(i) *In general.* The failure of an issuer to perform its obligations under a debt instrument is not itself an alteration of a legal right or obligation and is not a modification.

(ii) *Holder's temporary forbearance.* Notwithstanding paragraph (c)(1) of this section, absent a written or oral agreement to alter other terms of the debt instrument, an agreement by the

holder to stay collection or temporarily waive an acceleration clause or similar default right (including such a waiver following the exercise of a right to demand payment in full) is not a modification unless and until the forbearance remains in effect for a period that exceeds—

(A) Two years following the issuer's initial failure to perform; and

(B) Any additional period during which the parties conduct good faith negotiations or during which the issuer is in a title 11 or similar case (as defined in section 368(a)(3)(A)).

(5) *Failure to exercise an option.* If a party to a debt instrument has an option to change a term of an instrument, the failure of the party to exercise that option is not a modification.

(6) *Time of modification*—(i) *In general.* Except as provided in this paragraph (c)(6), an agreement to change a term of a debt instrument is a modification at the time the issuer and holder enter into the agreement, even if the change in the term is not immediately effective.

(ii) *Closing conditions.* If the parties condition a change in a term of a debt instrument on reasonable closing conditions (for example, shareholder, regulatory, or senior creditor approval, or additional financing), a modification occurs on the closing date of the agreement. Thus, if the reasonable closing conditions do not occur so that the change in the term does not become effective, a modification does not occur.

(iii) *Bankruptcy proceedings.* If a change in a term of a debt instrument occurs pursuant to a plan of reorganization in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), a modification occurs upon the effective date of the plan. Thus, unless the plan becomes effective, a modification does not occur.

(d) *Examples.* The following examples illustrate the provisions of paragraph (c) of this section:

Example 1. Reset bond. A bond provides for the interest rate to be reset every 49 days through an auction by a remarketing agent. The reset of the interest rate occurs by operation of the terms of the bond and is not an alteration described in paragraph (c)(2) of this section. Thus, the reset of the interest rate is not a modification.

Example 2. Obligation to maintain collateral. The original terms of a bond provide that the bond must be secured by a certain type of collateral having a specified value. The terms also require the issuer to substitute collateral if the value of the original collateral decreases. Any substitution of collateral that is required to maintain the value of the collateral occurs by operation of the terms of the bond and is not an alteration described in paragraph (c)(2) of this section. Thus, such a substitution of collateral is not a modification.

Example 3. Alteration contingent on an act of a party. The original terms of a bond provide that the interest rate is 9 percent. The terms also provide that, if the issuer files an effective registration statement covering the bonds with the Securities and Exchange Commission, the interest rate will decrease to 8 percent. If the issuer registers the bond, the resulting decrease in the interest rate occurs by operation of the terms of the bond and is not an alteration described in paragraph (c)(2) of this section. Thus, such a decrease in the interest rate is not a modification.

Example 4. Substitution of a new obligor occurring by operation of the terms of the debt instrument. Under the original terms of a bond issued by a corporation, an acquirer of substantially all of the corporation's assets may assume the corporation's obligations under the bond. Substantially all of the corporation's assets are acquired by another corporation and the acquiring corporation becomes the new obligor on the bond. Under paragraph (c)(2)(i) of this section, the substitution of a new obligor, even though it occurs by operation of the terms of the bond, is a modification.

Example 5. Defeasance with release of covenants. (i) A corporation issues a 30-year, recourse bond. Under the terms of the bond, the corporation may secure a release of the financial and restrictive covenants by placing in trust government securities as collateral that will provide interest and principal payments sufficient to satisfy all scheduled payments on the bond. The corporation remains obligated for all payments, including the contribution of additional securities to the trust if necessary to provide sufficient amounts to satisfy the payment obligations. Under paragraph (c)(3) of this section, the option to defease the bond is a unilateral option.

(ii) The alterations occur by operation of the terms of the debt instrument and are not described in paragraph (c)(2) of this section. Thus, such a release of the covenants is not a modification.

Example 6. Legal defeasance. Under the terms of a recourse bond, the issuer may secure a release of the financial and restrictive

covenants by placing in trust government securities that will provide interest and principal payments sufficient to satisfy all scheduled payments on the bond. Upon the creation of the trust, the issuer is released from any recourse liability on the bond and has no obligation to contribute additional securities to the trust if the trust funds are not sufficient to satisfy the scheduled payments on the bond. The release of the issuer is an alteration described in paragraph (c)(2)(i) of this section, and thus is a modification.

Example 7. Exercise of an option by a holder that reduces amounts payable. (i) A financial institution holds a residential mortgage. Under the original terms of the mortgage, the financial institution has an option to decrease the interest rate. The financial institution anticipates that, if market interest rates decline, it may exercise this option in lieu of the mortgagor refinancing with another lender.

(ii) The financial institution exercises the option to reduce the interest rate. The exercise of the option results in a reduction in scheduled payments and is an alteration described in paragraph (c)(2)(iii) of this section. Thus, the change in interest rate is a modification.

Example 8. Conversion of adjustable rate to fixed rate mortgage. (i) The original terms of a mortgage provide for a variable interest rate, reset annually based on the value of an objective index. Under the terms of the mortgage, the mortgagor may, upon the payment of a fee equal to a specified percentage of the outstanding principal amount of the mortgage, convert to a fixed rate of interest as determined based on the value of a second objective index. The exercise of the option does not require the consent or approval of any person or create a right of the holder to alter the terms of, or to put, the instrument.

(ii) Because the required consideration to exercise the option is a specified amount fixed on the issue date, the exercise of the option is unilateral as defined in paragraph (c)(3) of this section. The conversion to a fixed rate of interest is not an alteration described in paragraph (c)(2) of this section. Thus, the change in the type of interest rate occurs by operation of the terms of the instrument and is not a modification.

Example 9. Holder's option to increase interest rate. (i) A corporation issues an 8-year note to a bank in exchange for cash. Under the terms of the note, the bank has the option to increase the rate of interest by a specified amount if certain covenants in the note are breached. The bank's right to increase the interest rate is a unilateral option as described in paragraph (c)(3) of this section.

(ii) A covenant in the note is breached. The bank exercises its option to increase the rate of interest. The increase in the rate of interest occurs by operation of the terms of the note and does not result in a deferral or a reduction in the scheduled payments or any other alteration described in paragraph (c)(2) of this section. Thus, the change in interest rate is not a modification.

(iii) *Applicability date.* This *Example 9* applies to modifications occurring on or after July 6, 2011.

Example 10. Issuer's right to defer payment of interest. A corporation issues a 5-year note. Under the terms of the note, interest is payable annually at the rate of 10 percent. The corporation, however, has an option to defer any payment of interest until maturity. For any payments that are deferred, interest will compound at a rate of 12 percent. The exercise of the option, which results in the deferral of payments, does not result from the exercise of an option by the holder. The exercise of the option occurs by operation of the terms of the debt instrument and is not a modification.

Example 11. Holder's option to grant deferral of payment. (i) A corporation issues a 10-year note to a bank in exchange for cash. Interest on the note is payable semi-annually. Under the terms of the note, the bank may grant the corporation the right to defer all or part of the interest payments. For any payments that are deferred, interest will compound at a rate 150 basis points greater than the stated rate of interest.

(ii) The corporation encounters financial difficulty and is unable to satisfy its obligations under the note. The bank exercises its option under the note and grants the corporation the right to defer payments. The exercise of the option results in a right of the corporation to defer scheduled payments and, under paragraph (c)(3)(i) of this section, is not a unilateral option. Thus, the alteration is described in paragraph (c)(2)(iii) of this section and is a modification.

Example 12. Alteration requiring consent. The original terms of a bond include a provision that the issuer may extend the maturity of the bond with the consent of the holder. Because any extension pursuant to this term requires the consent of both parties, such an extension does not occur by the exercise of a unilateral option (as defined in paragraph (c)(3) of this section) and is a modification.

Example 13. Waiver of an acceleration clause. Under the terms of a bond, if the issuer fails to make a scheduled payment, the full principal amount of the bond is due and payable immediately. Following the issuer's failure to make a scheduled payment, the holder temporarily waives its right to receive the full principal for a period ending one year from the date of the issuer's default to allow the issuer to obtain additional financial resources. Under paragraph (c)(4)(ii) of this section, the temporary waiver in this situation is not a modification. The result would be the same if the terms provided the holder with the right to demand the full principal

amount upon the failure of the issuer to make a scheduled payment and, upon such a failure, the holder exercised that right and then waived the right to receive the payment for one year.

(e) *Significant modifications.* Whether the modification of a debt instrument is a significant modification is determined under the rules of this paragraph (e). Paragraph (e)(1) of this section provides a general rule for determining the significance of modifications not otherwise addressed in this paragraph (e). Paragraphs (e) (2) through (6) of this section provide specific rules for determining the significance of certain types of modifications. Paragraph (f) of this section provides rules of application, including rules for modifications that are effective on a deferred basis or upon the occurrence of a contingency.

(1) *General rule.* Except as otherwise provided in paragraphs (e)(2) through (e)(6) of this section, a modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant. In making a determination under this paragraph (e)(1), all modifications to the debt instrument (other than modifications subject to paragraphs (e) (2) through (6) of this section) are considered collectively, so that a series of such modifications may be significant when considered together although each modification, if considered alone, would not be significant.

(2) *Change in yield*—(i) *Scope of rule.* This paragraph (e)(2) applies to debt instruments that provide for only fixed payments, debt instruments with alternative payment schedules subject to § 1.1272–1(c), debt instruments that provide for a fixed yield subject to § 1.1272–1(d) (such as certain demand loans), and variable rate debt instruments. Whether a change in the yield of other debt instruments (for example, a contingent payment debt instrument) is a significant modification is determined under paragraph (e)(1) of this section.

(ii) *In general.* A change in the yield of a debt instrument is a significant modification if the yield computed under paragraph (e)(2)(iii) of this section varies from the annual yield on the unmodified instrument (determined as of the date of the modification) by more than the greater of—

(A) ¼ of one percent (25 basis points); or

(B) 5 percent of the annual yield of the unmodified instrument (.05 × annual yield).

(iii) *Yield of the modified instrument*—(A) *In general.* The yield computed under this paragraph (e)(2)(iii) is the annual yield of a debt instrument with—

(*1*) An issue price equal to the adjusted issue price of the unmodified instrument on the date of the modification (increased by any accrued but unpaid interest and decreased by any accrued bond issuance premium not yet taken into account, and increased or decreased, respectively, to reflect payments made to the issuer or to the holder as consideration for the modification); and

(*2*) Payments equal to the payments on the modified debt instrument from the date of the modification.

(B) *Prepayment penalty.* For purposes of this paragraph (e)(2)(iii), a commercially reasonable prepayment penalty for a pro rata prepayment (as defined in § 1.1275–2(f)) is not consideration for a modification of a debt instrument and is not taken into account in determining the yield of the modified instrument.

(iv) *Variable rate debt instruments.* For purposes of this paragraph (e)(2), the annual yield of a variable rate debt instrument is the annual yield of the equivalent fixed rate debt instrument (as defined in § 1.1275–5(e)) which is constructed based on the terms of the instrument (either modified or unmodified, whichever is applicable) as of the date of the modification.

(3) *Changes in timing of payments*—(i) *In general.* A modification that changes the timing of payments (including any resulting change in the amount of payments) due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. The deferral may occur either through an extension of the final maturity date of an instrument or through a deferral of payments due prior to maturity. The materiality of the deferral depends on all the facts

and circumstances, including the length of the deferral, the original term of the instrument, the amounts of the payments that are deferred, and the time period between the modification and the actual deferral of payments.

(ii) *Safe-harbor period*. The deferral of one or more scheduled payments within the safe-harbor period is not a material deferral if the deferred payments are unconditionally payable no later than at the end of the safe-harbor period. The safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50 percent of the original term of the instrument. For purposes of this paragraph (e)(3)(ii), the term of an instrument is determined without regard to any option to extend the original maturity and deferrals of de minimis payments are ignored. If the period during which payments are deferred is less than the full safe-harbor period, the unused portion of the period remains a safe-harbor period for any subsequent deferral of payments on the instrument.

(4) *Change in obligor or security*—(i) *Substitution of a new obligor on recourse debt instruments*—(A) *In general*. Except as provided in paragraph (e)(4)(i) (B), (C), or (D) of this section, the substitution of a new obligor on a recourse debt instrument is a significant modification.

(B) *Section 381(a) transaction*. The substitution of a new obligor is not a significant modification if the acquiring corporation (within the meaning of section 381) becomes the new obligor pursuant to a transaction to which section 381(a) applies, the transaction does not result in a change in payment expectations, and the transaction (other than a reorganization within the meaning of section 368(a)(1)(F)) does not result in a significant alteration.

(C) *Certain asset acquisitions*. The substitution of a new obligor is not a significant modification if the new obligor acquires substantially all of the assets of the original obligor, the transaction does not result in a change in payment expectations, and the transaction does not result in a significant alteration.

(D) *Tax-exempt bonds*. The substitution of a new obligor on a tax-exempt bond is not a significant modification if the new obligor is a related entity to the original obligor as defined in section 168(h)(4)(A) and the collateral securing the instrument continues to include the original collateral.

(E) *Significant alteration*. For purposes of this paragraph (e)(4), a significant alteration is an alteration that would be a significant modification but for the fact that the alteration occurs by operation of the terms of the instrument.

(F) *Section 338 election*. For purposes of this section, an election under section 338 following a qualified stock purchase of an issuer's stock does not result in the substitution of a new obligor.

(G) *Bankruptcy proceedings*. For purposes of this section, the filing of a petition in a title 11 or similar case (as defined in section 368(a)(3)(A)) by itself does not result in the substitution of a new obligor.

(ii) *Substitution of a new obligor on nonrecourse debt instruments*. The substitution of a new obligor on a nonrecourse debt instrument is not a significant modification.

(iii) *Addition or deletion of co-obligor*. The addition or deletion of a co-obligor on a debt instrument is a significant modification if the addition or deletion of the co-obligor results in a change in payment expectations. If the addition or deletion of a co-obligor is part of a transaction or series of related transactions that results in the substitution of a new obligor, however, the transaction is treated as a substitution of a new obligor (and is tested under paragraph (e)(4)(i)) of this section rather than as an addition or deletion of a co-obligor.

(iv) *Change in security or credit enhancement*—(A) *Recourse debt instruments*. A modification that releases, substitutes, adds or otherwise alters the collateral for, a guarantee on, or other form of credit enhancement for a recourse debt instrument is a significant modification if the modification results in a change in payment expectations.

(B) *Nonrecourse debt instruments*. (*1*) A modification that releases, substitutes,

adds or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for a nonrecourse debt instrument is a significant modification. A substitution of collateral is not a significant modification, however, if the collateral is fungible or otherwise of a type where the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type and credit quality). In addition, the substitution of a similar commercially available credit enhancement contract is not a significant modification, and an improvement to the property securing a nonrecourse debt instrument does not result in a significant modification.

(*2*) *Applicability date*. Paragraph (e)(4)(iv)(B)(*1*) of this section applies to modifications occurring on or after July 6, 2011.

(v) *Change in priority of debt*. A change in the priority of a debt instrument relative to other debt of the issuer is a significant modification if it results in a change in payment expectations.

(vi) *Change in payment expectations*—(A) *In general*. For purposes of this section, a change in payment expectations occurs if, as a result of a transaction—

(*1*) There is a substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was primarily speculative prior to the modification and is adequate after the modification; or

(*2*) There is a substantial impairment of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was adequate prior to the modification and is primarily speculative after the modification.

(B) *Obligor's capacity*. The obligor's capacity includes any source for payment, including collateral, guarantees, or other credit enhancement.

(5) *Changes in the nature of a debt instrument*—(i) *Property that is not debt*. A modification of a debt instrument that results in an instrument or property right that is not debt for Federal income tax purposes is a significant modification. The rules of paragraph (f)(7) of this section apply to determine whether a modification results in an instrument or property right that is not debt.

(ii) *Change in recourse nature*—(A) *In general*. Except as provided in paragraph (e)(5)(ii)(B) of this section, a change in the nature of a debt instrument from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse) is a significant modification. Thus, for example, a legal defeasance of a debt instrument in which the issuer is released from all liability to make payments on the debt instrument (including an obligation to contribute additional securities to a trust if necessary to provide sufficient funds to meet all scheduled payments on the instrument) is a significant modification. Similarly, a change in the nature of the debt instrument from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse) is a significant modification. If an instrument is not substantially all recourse or not substantially all nonrecourse either before or after a modification, the significance of the modification is determined under paragraph (e)(1) of this section.

(B) *Exceptions*—(*1*) *Defeasance of tax-exempt bonds*. A defeasance of a tax-exempt bond is not a significant modification even if the issuer is released from any liability to make payments under the instrument if the defeasance occurs by operation of the terms of the original bond and the issuer places in trust government securities or tax-exempt government bonds that are reasonably expected to provide interest and principal payments sufficient to satisfy the payment obligations under the bond.

(*2*) *Original collateral*. (*i*) A modification that changes a recourse debt instrument to a nonrecourse debt instrument is not a significant modification if the instrument continues to be secured only by the original collateral and the modification does not result in a change in payment expectations. For this purpose, if the original collateral is fungible or otherwise of a type where

the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type and credit quality), replacement of some or all units of the original collateral with other units of the same or similar type and aggregate value is not considered a change in the original collateral.

(*ii*) *Applicability date*. Paragraph (e)(5)(ii)(B)(*2*)(*i*) of this section applies to modifications occurring on or after July 6, 2011.

(6) *Accounting or financial covenants*. A modification that adds, deletes, or alters customary accounting or financial covenants is not a significant modification.

(f) *Rules of application*—(1) *Testing for significance*—(i) *In general*. Whether a modification of any term is a significant modification is determined under each applicable rule in paragraphs (e) (2) through (6) of this section and, if not specifically addressed in those rules, under the general rule in paragraph (e)(1) of this section. For example, a deferral of payments that changes the yield of a fixed rate debt instrument must be tested under both paragraphs (e) (2) and (3) of this section.

(ii) *Contingent modifications*. If a modification described in paragraphs (e) (2) through (5) of this section is effective only upon the occurrence of a substantial contingency, whether or not the change is a significant modification is determined under paragraph (e)(1) of this section rather than under paragraphs (e) (2) through (5) of this section.

(iii) *Deferred modifications*. If a modification described in paragraphs (e) (4) and (5) of this section is effective on a substantially deferred basis, whether or not the change is a significant modification is determined under paragraph (e)(1) of this section rather than under paragraphs (e) (4) and (5) of this section.

(2) *Modifications that are not significant*. If a rule in paragraphs (e) (2) through (4) of this section prescribes a degree of change in a term of a debt instrument that is a significant modification, a change of the same type but of a lesser degree is not a significant modification under that rule. For example, a 20 basis point change in the yield of a fixed rate debt instrument is not a significant modification under paragraph (e)(2) of this section. Likewise, if a rule in paragraph (e)(4) of this section requires a change in payment expectations for a modification to be significant, a modification of the same type that does not result in a change in payment expectations is not a significant modification under that rule.

(3) *Cumulative effect of modifications*. Two or more modifications of a debt instrument over any period of time constitute a significant modification if, had they been done as a single change, the change would have resulted in a significant modification under paragraph (e) of this section. Thus, for example, a series of changes in the maturity of a debt instrument constitutes a significant modification if, combined as a single change, the change would have resulted in a significant modification. The significant modification occurs at the time that the cumulative modification would be significant under paragraph (e) of this section. In testing for a change of yield under paragraph (e)(2) of this section, however, any prior modification occurring more than 5 years before the date of the modification being tested is disregarded.

(4) *Modifications of different terms*. Modifications of different terms of a debt instrument, none of which separately would be a significant modification under paragraphs (e) (2) through (6) of this section, do not collectively constitute a significant modification. For example, a change in yield that is not a significant modification under paragraph (e)(2) of this section and a substitution of collateral that is not a significant modification under paragraph (e)(4)(iv) of this section do not together result in a significant modification. Although the significance of each modification is determined independently, in testing a particular modification it is assumed that all other simultaneous modifications have already occurred.

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

(i) *Issuer* and *obligor* are used interchangeably and mean the issuer of a debt instrument or a successor obligor.

(ii) *Variable rate debt instrument* and *contingent payment debt instrument* have the meanings given those terms in section 1275 and the regulations thereunder.

(iii) *Tax-exempt bond* means a state or local bond that satisfies the requirements of section 103(a).

(iv) *Conduit loan* and *conduit borrower* have the same meanings as in §1.150–1(b).

(6) *Certain rules for tax-exempt bonds*—(i) *Conduit loans*. For purposes of this section, the obligor of a tax-exempt bond is the entity that actually issues the bond and not a conduit borrower of bond proceeds. In determining whether there is a significant modification of a tax-exempt bond, however, transactions between holders of the tax-exempt bond and a borrower of a conduit loan may be an indirect modification under paragraph (a)(1) of this section. For example, a payment by the holder of a tax-exempt bond to a conduit borrower to waive a call right may result in an indirect modification of the tax-exempt bond by changing the yield on that bond.

(ii) *Recourse nature*—(A) *In general*. For purposes of this section, a tax-exempt bond that does not finance a conduit loan is a recourse debt instrument.

(B) *Proceeds used for conduit loans*. For purposes of this section, a tax-exempt bond that finances a conduit loan is a recourse debt instrument unless both the bond and the conduit loan are nonrecourse instruments.

(C) *Government securities as collateral*. Notwithstanding paragraphs (f)(6)(ii)(A) and (B) of this section, for purposes of this section a tax-exempt bond that is secured only by a trust holding government securities or tax-exempt government bonds that are reasonably expected to provide interest and principal payments sufficient to satisfy the payment obligations under the bond is a nonrecourse instrument.

(7) *Rules for determining whether an alteration or modification results in an instrument or property right that is not debt*—(i) *In general*. Except as provided in paragraph (f)(7)(ii) of this section, the determination of whether an instrument resulting from an alteration or modification of a debt instrument will be recharacterized as an instrument or property right that is not debt for Federal income tax purposes shall take into account all of the factors relevant to such a determination.

(ii) *Financial condition of the obligor*—(A) *Deterioration in financial condition of the obligor generally disregarded*. Except as provided in paragraph (f)(7)(ii)(B) of this section, in making a determination as to whether an instrument resulting from an alteration or modification of a debt instrument will be recharacterized as an instrument or property right that is not debt, any deterioration in the financial condition of the obligor between the issue date of the debt instrument and the date of the alteration or modification (as it relates to the obligor's ability to repay the debt instrument) is not taken into account. For example, any decrease in the fair market value of a debt instrument (whether or not the debt instrument is publicly traded) between the issue date of the debt instrument and the date of the alteration or modification is not taken into account to the extent that the decrease in fair market value is attributable to the deterioration in the financial condition of the obligor and not to a modification of the terms of the instrument.

(B) *Substitution of a new obligor; addition or deletion of co-obligor*. If there is a substitution of a new obligor or the addition or deletion of a co-obligor, the rules in paragraph (f)(7)(ii)(A) of this section do not apply.

(g) *Examples*. The following examples illustrate the provisions of paragraphs (e) and (f) of this section:

Example 1. Modification of call right. (i) Under the terms of a 30-year, fixed-rate bond, the issuer can call the bond for 102 percent of par at the end of ten years or for 101 percent of par at the end of 20 years. At the end of the eighth year, the holder of the bond pays the issuer to waive the issuer's right to call the bond at the end of the tenth year. On the date of the modification, the issuer's credit quality is approximately the same as when the bond was issued, but market rates of interest have declined from that date.

(ii) The holder's payment to the issuer changes the yield on the bond. Whether the change in yield is a significant modification depends on whether the yield on the modified bond varies from the yield on the original bond by more than the change in yield as described in paragraph (e)(2)(ii) of this section.

(iii) If the change in yield is not a significant modification, the elimination of the issuer's call right must also be tested for significance. Because the specific rules of paragraphs (e)(2) through (e)(6) of this section do not address this modification, the significance of the modification must be determined under the general rule of paragraph (e)(1) of this section.

(iv) *Applicability date.* This *Example 1* applies to modifications occurring on or after July 6, 2011.

Example 2. Extension of maturity and change in yield. (i) A zero-coupon bond has an original maturity of ten years. At the end of the fifth year, the parties agree to extend the maturity for a period of two years without increasing the stated redemption price at maturity (i.e., there are no additional payments due between the original and extended maturity dates, and the amount due at the extended maturity date is equal to the amount due at the original maturity date).

(ii) The deferral of the scheduled payment at maturity is tested under paragraph (e)(3) of this section. The safe-harbor period under paragraph (e)(3)(ii) of this section starts with the date the payment that is being deferred is due. For this modification, the safe-harbor period starts on the original maturity date, and ends five years from this date. All payments deferred within this period are unconditionally payable before the end of the safe-harbor period. Thus, the deferral of the payment at maturity for a period of two years is not a material deferral under the safe-harbor rule of paragraph (e)(3)(ii) of this section and thus is not a significant modification.

(iii) Even though the extension of maturity is not a significant modification under paragraph (e)(3)(ii) of this section, the modification also decreases the yield of the bond. The change in yield must be tested under paragraph (e)(2) of this section.

Example 3. Change in yield resulting from reduction of principal. (i) A debt instrument issued at par has an original maturity of ten years and provides for the payment of $100,000 at maturity with interest payments at the rate of 10 percent payable at the end of each year. At the end of the fifth year, and after the annual payment of interest, the issuer and holder agree to reduce the amount payable at maturity to $80,000. The annual interest rate remains at 10 percent but is payable on the reduced principal.

(ii) In applying the change in yield rule of paragraph (e)(2) of this section, the yield of the instrument after the modification (measured from the date that the parties agree to the modification to its final maturity date) is computed using the adjusted issue price of $100,000. With four annual payments of $8,000, and a payment of $88,000 at maturity, the yield on the instrument after the modification for purposes of determining if there has been a significant modification under paragraph (e)(2)(i) of this section is 4.332 percent. Thus, the reduction in principal is a significant modification.

Example 4. Deferral of scheduled interest payments. (i) A 20-year debt instrument issued at par provides for the payment of $100,000 at maturity with annual interest payments at the rate of 10 percent. At the beginning of the eleventh year, the issuer and holder agree to defer all remaining interest payments until maturity with compounding. The yield of the modified instrument remains at 10 percent.

(ii) The safe-harbor period of paragraph (e)(3)(ii) of this section begins at the end of the eleventh year, when the interest payment for that year is deferred, and ends at the end of the sixteenth year. However, the payments deferred during this period are not unconditionally payable by the end of that 5-year period. Thus, the deferral of the interest payments is not within the safe-harbor period.

(iii) This modification materially defers the payments due under the instrument and is a significant modification under paragraph (e)(3)(i) of this section.

Example 5. Assumption of mortgage with increase in interest rate. (i) A recourse debt instrument with a 9 percent annual yield is secured by an office building. Under the terms of the instrument, a purchaser of the building may assume the debt and be substituted for the original obligor if the purchaser is equally or more creditworthy than the original obligor and if the interest rate on the instrument is increased by one-half percent (50 basis points). The building is sold, the purchaser assumes the debt, and the interest rate increases by 50 basis points.

(ii) If the purchaser's acquisition of the building does not satisfy the requirements of paragraph (e)(4)(i)(B) or paragraph (e)(4)(i)(C) of this section, the substitution of the purchaser as the obligor is a significant modification under paragraph (e)(4)(i)(A) of this section.

(iii) If the purchaser acquires substantially all of the assets of the original obligor, the assumption of the debt instrument will not result in a significant modification if there is not a change in payment expectations and the assumption does not result in a significant alteration.

(iv) The change in the interest rate, if tested under the rules of paragraph (e)(2) of this section, would result in a significant modification. The change in interest rate that results from the transaction is a significant alteration. Thus, the transaction does not meet the requirements of paragraph (e)(4)(i)(C) of this section and is a significant modification under paragraph (e)(4)(i)(A) of this section.

(v) *Applicability date.* This *Example 5* applies to modifications occurring on or after July 6, 2011.

Example 6. Assumption of mortgage. (i) A recourse debt instrument is secured by a building. In connection with the sale of the building, the purchaser of the building assumes the debt and is substituted as the new obligor on the debt instrument. The purchaser does not acquire substantially all of the assets of the original obligor.

(ii) The transaction does not satisfy any of the exceptions set forth in paragraph (e)(4)(i)(B) or (C) of this section. Thus, the substitution of the purchaser as the obligor is a significant modification under paragraph (e)(4)(i)(A) of this section.

(iii) Section 1274(c)(4), however, provides that if a debt instrument is assumed in connection with the sale or exchange of property, the assumption is not taken into account in determining if section 1274 applies to the debt instrument unless the terms and conditions of the debt instrument are modified in connection with the sale or exchange. Because the purchaser assumed the debt instrument in connection with the sale of property and the debt instrument was not otherwise modified, the debt instrument is not retested to determine whether it provides for adequate stated interest.

Example 7. Substitution of a new obligor in section 381(a) transaction. (i) The interest rate on a 30-year debt instrument issued by a corporation provides for a variable rate of interest that is reset annually on June 1st based on an objective index.

(ii) In the tenth year, the issuer merges (in a transaction to which section 381(a) applies) into another corporation that becomes the new obligor on the debt instrument. The merger occurs on June 1st, at which time the interest rate is also reset by operation of the terms of the instrument. The new interest rate varies from the previous interest rate by more than the greater of 25 basis points and 5 percent of the annual yield of the unmodified instrument. The substitution of a new obligor does not result in a change in payment expectations.

(iii) The substitution of the new obligor occurs in a section 381(a) transaction and does not result in a change in payment expectations. Although the interest rate changed by more than the greater of 25 basis points and 5 percent of the annual yield of the unmodified instrument, this alteration did not occur as a result of the transaction and is not a significant alteration under paragraph (e)(4)(i)(E) of this section. Thus, the substitution meets the requirements of paragraph (e)(4)(i)(B) of this section and is not a significant modification.

Example 8. Substitution of credit enhancement contract. (i) Under the terms of a recourse debt instrument, the issuer's obligations are secured by a letter of credit from a specified bank. The debt instrument does not contain any provision allowing a substitution of a letter of credit from a different bank. The specified bank, however, encounters financial difficulty. The issuer and holder agree that the issuer will substitute a letter of credit from another bank.

(ii) Under paragraph (e)(4)(iv)(A) of this section, the substitution of a different credit enhancement contract is not a significant modification of a recourse debt instrument unless the substitution results in a change in payment expectations. While the substitution of a new letter of credit by a different bank does not itself result in a change in payment expectations, such a substitution may result in a change in payment expectations under certain circumstances (for example, if the obligor's capacity to meet payment obligations is dependent on the letter of credit and the substitution substantially enhances that capacity from primarily speculative to adequate).

(iii) *Applicability date.* This *Example 8* applies to modifications occurring on or after July 6, 2011.

Example 9. Improvement to collateral securing nonrecourse debt. A parcel of land and its improvements, a shopping center, secure a nonrecourse debt instrument. The obligor expands the shopping center with the construction of an additional building on the same parcel of land. After the construction, the improvements that secure the nonrecourse debt include the new building. The building is an improvement to the property securing the nonrecourse debt instrument and its inclusion in the collateral securing the debt is not a significant modification under paragraph (e)(4)(iv)(B) of this section.

(h) *Effective/applicability date*—(1) *In general.* Except as otherwise provided in paragraph (h)(2) of this section, this section applies to alterations of the terms of a debt instrument on or after September 24, 1996. Taxpayers, however, may rely on this section for alterations of the terms of a debt instrument after December 2, 1992, and before September 24, 1996.

(2) *Exception.* Paragraph (f)(7) of this section applies to an alteration of the terms of a debt instrument on or after January 7, 2011. A taxpayer, however, may rely on paragraph (f)(7) of this section for alterations of the terms of a debt instrument occurring before that date.

[T.D. 8675, 61 FR 32930, June 26, 1996; 61 FR 47822, Sept. 11, 1996; 76 FR 1064, Jan. 7, 2011; T.D. 9533, 76 FR 39282, July 6, 2011; T.D. 9637, 78 FR 54760, Sept. 6, 2013]

§ 1.1001–4 Modifications of certain derivative contracts.

(a) *Certain assignments*. For purposes of § 1.1001–1(a), the transfer or assignment of a derivative contract is not treated by the nonassigning counterparty as a deemed exchange of the original contract for a modified contract that differs materially either in kind or in extent if—

(1) Both the party transferring or assigning its rights and obligations under the derivative contract and the party to which the rights and obligations are transferred or assigned are either a dealer or a clearinghouse;

(2) The terms of the derivative contract permit the transfer or assignment of the contract, whether or not the consent of the nonassigning counterparty is required for the transfer or assignment to be effective; and

(3) The terms of the derivative contract are not otherwise modified in a manner that results in a taxable exchange under section 1001.

(b) *Definitions*—(1) *Dealer*. For purposes of this section, a *dealer* is a taxpayer who meets the definition of a dealer in securities in section 475(c)(1) or is a dealer in commodities derivative contracts.

(2) *Clearinghouse*. For purposes of this section, a *clearinghouse* is a derivatives clearing organization (as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a)) or a clearing agency (as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))) that is registered, or exempt from registration, under each respective Act.

(3) *Derivative contract*. For purposes of this section, a *derivative contract* is a contract described in—

(i) Section 475(c)(2)(D), 475(c)(2)(E), or 475(c)(2)(F) without regard to the last sentence of section 475(c)(2) referencing section 1256;

(ii) Section 475(e)(2)(B), 475(e)(2)(C), or 475(e)(2)(D); or

(iii) Section 1.446–3(c)(1).

(c) *Consideration for the assignment*. Any payment between a party transferring or assigning its rights and obligations under the contract and the party to which the rights and obligations are transferred or assigned pursuant to a transfer or assignment described in paragraph (a) of this section will not affect the treatment of the nonassigning counterparty for purposes of this section. A payment described in the preceding sentence made or received to transfer or assign rights and obligations under a notional principal contract (as defined in § 1.446–3(c)(1)) is not subject to § 1.446–3(g)(4).

(d) *Effective/applicability date*. This section applies to transfers or assignments of derivative contracts on or after July 22, 2011.

[T.D. 9639, 78 FR 66640, Nov. 6, 2013]

§ 1.1001–5 European Monetary Union (conversion to the euro).

(a) *Conversion of currencies*. For purposes of § 1.1001–1(a), the conversion to the euro of legacy currencies (as defined in § 1.985–8(a)(1)) is not the exchange of property for other property differing materially in kind or extent.

(b) *Effect of currency conversion on other rights and obligations*. For purposes of § 1.1001–1(a), if, solely as the result of the conversion of legacy currencies to the euro, rights or obligations denominated in a legacy currency become rights or obligations denominated in the euro, that event is not the exchange of property for other property differing materially in kind or extent. Thus, for example, when a debt instrument that requires payments of amounts denominated in a legacy currency becomes a debt instrument requiring payments of euros, that alteration is not a modification within the meaning of § 1.1001–3(c).

(c) *Effective date*. This section applies to tax years ending after July 29, 1998.

[T.D. 8927, 66 FR 2218, Jan. 11, 2001]

§ 1.1002–1 Sales or exchanges.

(a) *General rule*. The general rule with respect to gain or loss realized upon the sale or exchange of property as determined under section 1001 is that the entire amount of such gain or loss is recognized except in cases where specific provisions of subtitle A of the code provide otherwise.

(b) *Strict construction of exceptions from general rule*. The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of

general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

(c) *Certain exceptions to general rule.* Exceptions to the general rule are made, for example, by sections 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, 1035 and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

(d) *Exchange.* Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

BASIS RULES OF GENERAL APPLICATION

§ 1.1011–1 Adjusted basis.

The adjusted basis for determining the gain or loss from the sale or other disposition of property is the cost or other basis prescribed in section 1012 or other applicable provisions of subtitle A of the code, adjusted to the extent provided in sections 1016, 1017, and 1018 or as otherwise specifically provided for under applicable provisions of internal revenue laws.

§ 1.1011–2 Bargain sale to a charitable organization.

(a) *In general.* (1) If for the taxable year a charitable contributions deduction is allowable under section 170 by reason of a sale or exchange of property, the taxpayer's adjusted basis of such property for purposes of determining gain from such sale or exchange must be computed as provided in section 1011(b) and paragraph (b) of this section. If after applying the provisions of section 170 for the taxable year, including the percentage limitations of section 170(b), no deduction is allowable under that section by reason of the sale or exchange of the property, section 1011(b) does not apply and the adjusted basis of the property is not required to be apportioned pursuant to paragraph (b) of this section. In such case the entire adjusted basis of the property is to be taken into account in determining gain from the sale or exchange, as provided in § 1.1011–1(e). In ascertaining whether or not a charitable contributions deduction is allowable under section 170 for the taxable year for such purposes, that section is to be applied without regard to this section and the amount by which the contributed portion of the property must be reduced under section 170(e)(1) is the amount determined by taking into account the amount of gain which would have been ordinary income or long-term capital gain if the contributed portion of the property had been sold by the donor at its fair market value at the time of the sale or exchange.

(2) If in the taxable year there is a sale or exchange of property which gives rise to a charitable contribution which is carried over under section 170(b)(1)(D)(ii) or section 170(d) to a subsequent taxable year or is postponed under section 170(a)(3) to a subsequent taxable year, section 1011(b) and paragraph (b) of this section must be applied for purposes of apportioning the adjusted basis of the property for

the year of the sale or exchange, whether or not such contribution is allowable as a deduction under section 170 in such subsequent year.

(3) If property is transferred subject to an indebtedness, the amount of the indebtedness must be treated as an amount realized for purposes of determining whether there is a sale or exchange to which section 1011(b) and this section apply, even though the transferee does not agree to assume or pay the indebtedness.

(4)(i) Section 1011(b) and this section apply where property is sold or exchanged in return for an obligation to pay an annuity and a charitable contributions deduction is allowable under section 170 by reason of such sale or exchange.

(ii) If in such case the annuity received in exchange for the property is nonassignable, or is assignable but only to the charitable organization to which the property is sold or exchanged, and if the transferor is the only annuitant or the transferor and a designated survivor annuitant or annuitants are the only annuitants, any gain on such exchange is to be reported as provided in example (8) in paragraph (c) of this section. In determining the period over which gain may be reported as provided in such example, the life expectancy of the survivor annuitant may not be taken into account. The fact that the transferor may retain the right to revoke the survivor's annuity or relinquish his own right to the annuity will not be considered, for purposes of this subdivision, to make the annuity assignable to someone other than the charitable organization. Gain on an exchange of the type described in this subdivision pursuant to an agreement which is entered into after December 19, 1969, and before May 3, 1971, may be reported as provided in example (8) in paragraph (c) of this section, even though the annuity is assignable.

(iii) In the case of an annuity to which subdivision (ii) of this subparagraph applies, the gain unreported by the transferor with respect to annuity payments not yet due when the following events occur is not required to be included in gross income of any person where—

(*a*) The transferor dies before the entire amount of gain has been reported and there is no surviving annuitant, or

(*b*) The transferor relinquishes the annuity to the charitable organization.

If the transferor dies before the entire amount of gain on a two-life annuity has been reported, the unreported gain is required to be reported by the surviving annuitant or annuitants with respect to the annuity payments received by them.

(b) *Apportionment of adjusted basis.* For purposes of determining gain on a sale or exchange to which this paragraph applies, the adjusted basis of the property which is sold or exchanged shall be that portion of the adjusted basis of the entire property which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the entire property. The amount of such gain which shall be treated as ordinary income (or long-term capital gain) shall be that amount which bears the same ratio to the ordinary income (or long-term capital gain) which would have been recognized if the entire property had been sold by the donor at its fair market value at the time of the sale or exchange as the amount realized on the sale or exchange bears to the fair market value of the entire property at such time. The terms *ordinary income* and *long-term capital gain*, as used in this section, have the same meaning as they have in paragraph (a) of § 1.170A–4. For determining the portion of the adjusted basis, ordinary income, and long- term capital gain allocated to the contributed portion of the property for purposes of applying section 170(e)(1) and paragraph (a) of § 1.170A–4 to the contributed portion of the property, and for determining the donee's basis in such contributed portion, see paragraph (c) (2) and (4) of § 1.170A–4. For determining the holding period of such contributed portion, see section 1223(2) and the regulations thereunder.

(c) *Illustrations.* The application of this section may be illustrated by the following examples, which are supplemented by other examples in paragraph (d) of § 1.170A–4:

Example 1. In 1970, A, a calendar-year individual taxpayer, sells to a church for $4,000 stock held for more than 6 months which has

an adjusted basis of $4,000 and a fair market value of $10,000. A's contribution base for 1970, as defined in section 170(b)(1)(F), is $100,000, and during that year he makes no other charitable contributions. Thus, A makes a charitable contribution to the church of $6,000 ($10,000 value −$4,000 amount realized). Without regard to this section, A is allowed a deduction under section 170 of $6,000 for his charitable contribution to the church, since there is no reduction under section 170(e)(1) with respect to the long-term capital gain. Accordingly, under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $1,600 ($4,000 adjusted basis × $4,000 amount realized / $10,000 value of property). A has recognized long-term capital gain of $2,400 ($4,000 amount realized − $1,600 adjusted basis) on the bargain sale.

Example 2. The facts are the same as in example (1) except that A also makes a charitable contribution in 1970 of $50,000 cash to the church. By reason of section 170(b)(1)(A), the deduction allowed under section 170 for 1970 is $50,000 for the amount of cash contributed to the church; however, the $6,000 contribution of property is carried over to 1971 under section 170(d). Under paragraphs (a)(2) and (b) of this section the adjusted basis for determining gain for 1970 on the bargain sale in that year is $1,600 ($4,000 × $4,000 / $10,000). A has a recognized long-term capital gain for 1970 of $2,400 ($4,000 − $1,600) on the sale.

Example 3. In 1970, C, a calendar-year individual taxpayer, makes a charitable contribution of $50,000 cash to a church. In addition, he sells for $4,000 to a private foundation not described in section 170(b)(1)(E) stock held for more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. Thus, C makes a charitable contribution of $6,000 of such property to the private foundation ($10,000 value − $4,000 amount realized). C's contribution base for 1970, as defined in section 170(b)(1)(F), is $100,000, and during that year he makes no other charitable contributions. By reason of section 170(b)(1)(A), the deduction allowed under section 170 for 1970 is $50,000 for the amount of cash contributed to the church. Under section 170(e)(1)(B)(ii) and paragraphs (a)(1) and (c)(2)(i) of § 1.170A–4, the $6,000 contribution of stock is reduced to $4,800 ($6,000 − [50% × ($6,000 value of contributed portion of stock − $3,600 adjusted basis)]). However, by reason of section 170(b)(1)(B)(ii), applied without regard to section 1011(b), no deduction is allowed under section 170 for 1970 or any other year for the reduced contribution of $4,800 to the private foundation. Accordingly, paragraph (b) of this section does not apply for purposes of apportioning the adjusted basis of the stock sold to the private foundation, and under section 1.1011–1(e) the recognized gain on the bargain sale is $0 ($4,000 amount realized − $4,000 adjusted basis).

Example 4. In 1970, B, a calendar-year individual taxpayer, sells to a church for $2,000 stock held for not more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. B's contribution base for 1970, as defined in section 170(b)(1)(F), is $20,000 and during such year B makes no other charitable contributions. Thus, he makes a charitable contribution to the church of $8,000 ($10,000 value − $2,000 amount realized). Under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $800 ($4,000 adjusted basis × $2,000 amount realized / $10,000 value of stock). Accordingly, B, has a recognized short-term capital gain of $1,200 ($2,000 amount realized − $800 adjusted basis) on the bargain sale. After applying section 1011(b) and paragraphs (a)(1) and (c)(2)(i) of § 1.170A–4, B is allowed a charitable contributions deduction for 1970 of $3,200 ($8,000 value of gift − [$8,000 − ($4,000 adjusted basis of property × $8,000 value of gift / $10,000 value of property)]).

Example 5. The facts are the same as in Example 4 except that B sells the property to the church for $4,000. Thus, B makes a charitable contribution to the church of $6,000 ($10,000 value −$4,000 amount realized). Under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $1,600 ($4,000 adjusted basis × $4,000 amount realized / $10,000 value of stock). Accordingly, B has a recognized short-term capital gain of $2,400 ($4,000 amount realized − $1,600 adjusted basis) on the bargain sale. After applying section 1011(b) and paragraphs (a)(1) and (c)(2)(i) of § 1.170A–4, B is allowed a charitable contributions deduction for 1970 of $2,400 ($6,000 value of gift − [$6,000 − ($4,000 adjusted basis of property × $6,000 value of gifts / $10,000 value of property)]).

Example 6. The facts are the same as in Example 4 except that B sells the property to the church for $6,000. Thus, B makes a charitable contribution to the church of $4,000 ($10,000 value −$6,000 amount realized). Under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $2,400 ($4,000 adjusted basis × $6,000 amount realized/$10,000 value of stock). Accordingly, B has a recognized short-term capital gain of $3,600 ($6,000 amount realized −$2,400 adjusted basis) on the bargain sale. After applying section 1011(b) and paragraphs (a)(1) and (c)(2)(i) of § 1.170A–4, B is allowed a charitable contributions deduction for 1970 of $1,600 ($4,000 value of gift −[$4,000 −($4,000 adjusted basis of property × $4,000 value of gift/$10,000 value of property]).

Example 7. In 1970, C, a calendar-year individual taxpayer, sells to a church for $4,000 tangible personal property used in his business for more than 6 months which has an

adjusted basis of $4,000 and a fair market value of $10,000. Thus, C makes a charitable contribution to the church of $6,000 ($10,000 value −$4,000 adjusted basis). C's contribution base for 1970, as defined in section 170(b)(1)(F) is $100,000 and during such year he makes no other charitable contributions. If C had sold the property at its fair market value at the time of its contribution, it is assumed that under section 1245 $4,000 of the gain of $6,000 ($10,000 value −$4,000 adjusted basis) would have been treated as ordinary icome. Thus, there would have been long-term capital gain of $2,000. It is also assumed that the church does not put the property to an unrelated use, as defined in paragraph (b)(3) of § 1.170A–4. Under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $1,600 ($4,000 adjusted basis × $4,000 amount realized/$10,000 value of property). Accordingly, C has a recognized gain of $2,400 ($4,000 amount realized −$1,600 adjusted basis) on the bargain sale, consisting of ordinary income of $1,600 ($4,000 ordinary income × $4,000 amount realized/$10,000 value of property) and of long-term capital gain of $800 ($2,000 long-term gain × $4,000 amount realized/$10,000 value of property). After applying section 1011(b) and paragraphs (a) and (c)(2)(i) of § 1.170A–4, C is allowed a charitable contributions deduction for 1970 of $3,600 ($6,000 gift −[$4,000 ordinary income × $6,000 value of gift/$10,000 value of property]).

Example 8. (a) On January 1, 1970, A, a male of age 65, transfers capital assets consisting of securities held for more than 6 months to a church in exchange for a promise by the church to pay A a nonassignable annuity of $5,000 per year for life. The annuity is payable monthly with the first payment to be made on February 1, 1970. A's contribution base for 1970, as defined in section 170(b)(1)(F), is $200,000, and during that year he makes no other charitable contributions. On the date of transfer the securities have a fair market value of $100,000 and an adjusted basis to A of $20,000.

(b) The present value of the right of a male age 65 to receive a life annuity of $5,000 per annum, payable in equal installments at the end of each monthly period, is $59,755 ($5,000 × [11.469 + 0.482]), determined in accordance with section 101(b) of the Code, paragraph (e)(1)(iii)(b)(2) of § 1.101–2, and section 3 of Rev. Rul. 62–216, C.B. 1962–2, 30. Thus, A makes a charitable contribution to the church of $40,245 ($100,000 −$59,755). See Rev. Rul. 84–162, 1984–2 C.B. 200, for transfers for which the valuation date falls after November 23, 1984. (See § 601.601(d)(2)(ii)(*b*) of this chapter). For the applicable valuation tables in connection therewith, see § 20.2031–7(d)(6) of this chapter. See, however, § 1.7520–3(b) (relating to exceptions to the use of standard actuarial factors in certain circumstances).

(c) Under paragraph (b) of this section, the adjusted basis for determining gain on the bargain sale is $11,951 ($20,000 × $59,755 / $100,000). Accordingly, A has a recognized long-term capital gain of $47,804 ($59,755 − $11,951) on the bargain sale. Such gain is to be reported by A ratably over the period of years measured by the expected return multiple under the contract, but only from that portion of the annual payments which is a return of his investment in the contract under section 72 of the Code. For such purposes, the investment in the contract is $59,755, that is, the present value of the annuity.

(d) The computation and application of the exclusion ratio, the gain, and the ordinary annuity income are as follows, determined by using the expected return multiple of 15.0 applicable under table I of § 1.72–9:

A's expected return (annual payments of $5,000 × 15)	$75,000.00
Exclusion ratio ($59,755 investment in contract divided by expected return of $75,000)	79.7%
Annual exclusion (annual payments of $5,000 × 79.7%)	$3,985.00
Ordinary annuity income ($5,000 − $3,985)	$1,015.00
Long-term capital gain per year ($47,804/15) with respect to the annual exclusion	$3,186.93

(e) The exclusion ratio of 79.7 percent applies throughout the life of the contract. During the first 15 years of the annuity, A is required to report ordinary income of $1,015 and long-term capital gain of $3,186.93 with respect to the annuity payments he receives. After the total long-term capital gain of $47,804 has been reported by A, he is required to report only ordinary income of $1,015.00 per annum with respect to the annuity payments he receives.

(d) *Effective date.* This section applies only to sales and exchanges made after December 19, 1969.

(e) *Cross reference.* For rules relating to the treatment of liabilities on the sale or other disposition or encumbered property, see § 1.1001–2.

[T.D. 7207, 37 FR 20798, Oct. 5, 1972, as amended by T.D. 7741, 45 FR 81745, Dec. 12, 1980; T.D. 8176, 53 FR 5570, Feb. 25, 1988; 53 FR 11002, Apr. 4, 1988; T.D. 8540, 59 FR 30148, June 10, 1994]

§ 1.1012–1 Basis of property.

(a) *General rule.* In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property. This general rule is subject to exceptions stated in subchapter O (relating to gain or loss on the disposition of property), subchapter C (relating to corporate distributions and adjustments), subchapter K (relating to partners and

partnerships), and subchapter P (relating to capital gains and losses), chapter 1 of the code.

(b) *Real estate taxes as part of cost.* In computing the cost of real property, the purchaser shall not take into account any amount paid to the seller as reimbursement for real property taxes which are treated under section 164(d) as imposed upon the purchaser. This rule applies whether or not the contract of sale calls for the purchaser to reimburse the seller for such real estate taxes paid or to be paid by the seller. On the other hand, where the purchaser pays (or assumes liability for) real estate taxes which are treated under section 164(d) as imposed upon the seller, such taxes shall be considered part of the cost of the property. It is immaterial whether or not the contract of sale specifies that the sale price has been reduced by, or is in any way intended to reflect, real estate taxes allocable to the seller under section 164(d). For illustrations of the application of this paragraph, see paragraph (b) of § 1.1001–1.

(c) *Sale of stock*—(1) *In general.* (i) Except as provided in paragraph (e)(2) of this section (dealing with stock for which the average basis method is permitted), if a taxpayer sells or transfers shares of stock in a corporation that the taxpayer purchased or acquired on different dates or at different prices and the taxpayer does not adequately identify the lot from which the stock is sold or transferred, the stock sold or transferred is charged against the earliest lot the taxpayer purchased or acquired to determine the basis and holding period of the stock. If the earliest lot purchased or acquired is held in a stock certificate that represents multiple lots of stock, and the taxpayer does not adequately identify the lot from which the stock is sold or transferred, the stock sold or transferred is charged against the earliest lot included in the certificate. See paragraphs (c)(2), (c)(3), and (c)(4) of this section for rules on what constitutes an adequate identification.

(ii) A taxpayer must determine the basis of identical stock (within the meaning of paragraph (e)(4) of this section) by averaging the cost of each share if the stock is purchased at separate times on the same calendar day in executing a single trade order and the broker executing the trade provides a single confirmation that reports an aggregate total cost or an average cost per share. However, the taxpayer may determine the basis of the stock by the actual cost per share if the taxpayer notifies the broker in writing of this intent. The taxpayer must notify the broker by the earlier of the date of the sale of any of the stock for which the taxpayer received the confirmation or one year after the date of the confirmation. A broker may extend the one-year period but the taxpayer must notify the broker no later than the date of sale of any of the stock.

(2) *Identification of stock.* An adequate identification is made if it is shown that certificates representing shares of stock from a lot which was purchased or acquired on a certain date or for a certain price were delivered to the taxpayer's transferee. Except as otherwise provided in subparagraph (3) or (4) of this paragraph, such stock certificates delivered to the transferee constitute the stock sold or transferred by the taxpayer. Thus, unless the requirements of subparagraph (3) or (4) of this paragraph are met, the stock sold or transferred is charged to the lot to which the certificates delivered to the transferee belong, whether or not the taxpayer intends, or instructs his broker or other agent, to sell or transfer stock from a lot purchased or acquired on a different date or for a different price.

(3) *Identification on confirmation document.* (i) Where the stock is left in the custody of a broker or other agent, an adequate identification is made if—

(*a*) At the time of the sale or transfer, the taxpayer specifies to such broker or other agent having custody of the stock the particular stock to be sold or transferred, and

(*b*) Within a reasonable time thereafter, confirmation of such specification is set forth in a written document from such broker or other agent.

Stock identified pursuant to this subdivision is the stock sold or transferred by the taxpayer, even though stock certificates from a different lot are delivered to the taxpayer's transferee.

(ii) Where a single stock certificate represents stock from different lots, where such certificate is held by the taxpayer rather than his broker or other agent, and where the taxpayer sells a part of the stock represented by such certificate through a broker or other agent, an adequate identification is made if—

(*a*) At the time of the delivery of the certificate to the broker or other agent, the taxpayer specifies to such broker or other agent the particular stock to be sold or transferred, and

(*b*) Within a reasonable time thereafter, confirmation of such specification is set forth in a written document from such broker or agent.

Where part of the stock represented by a single certificate is sold or transferred directly by the taxpayer to the purchaser or transferee instead of through a broker or other agent, an adequate identification is made if the taxpayer maintains a written record of the particular stock which he intended to sell or transfer.

(4) *Stock held by a trustee, executor, or administrator.* (i) A trustee or executor or administrator of an estate holding stock (not left in the custody of a broker) makes an adequate identification if the trustee, executor, or administrator—

(*a*) Specifies in writing in the books and records of the trust or estate the particular stock to be sold, transferred, or distributed;

(*b*) In the case of a distribution, furnishes the distributee with a written document identifying the particular stock distributed; and

(*c*) In the case of a sale or transfer through a broker or other agent, specifies to the broker or agent the particular stock to be sold or transferred, and within a reasonable time thereafter the broker or agent confirms the specification in a written document.

(ii) The stock the trust or estate identifies under paragraph (c)(4)(i) of this section is the stock treated as sold, transferred, or distributed, even if the trustee, executor, or administrator delivers stock certificates from a different lot.

(5) *Subsequent sales.* If stock identified under subparagraph (3) or (4) of this paragraph as belonging to a particular lot is sold, transferred, or distributed, the stock so identified shall be deemed to have been sold, transferred, or distributed, and such sale, transfer, or distribution will be taken into consideration in identifying the taxpayer's remaining stock for purposes of subsequent sales, transfers, or distributions.

(6) *Bonds.* Paragraphs (1) through (5), (8), and (9) of this section apply to the sale or transfer of bonds.

(7) *Book-entry securities.* (i) In applying the provisions of subparagraph (3)(i)(*a*) of this paragraph in the case of a sale or transfer of a book-entry security (as defined in subdivision (iii) (*a*) of this subparagraph) which is made after December 31, 1970, pursuant to a written instruction by the taxpayer, a specification by the taxpayer of the unique lot number which he has assigned to the lot which contains the securities being sold or transferred shall constitute specification as required by such subparagraph. The specification of the lot number shall be made either—

(*a*) In such written instruction, or

(*b*) In the case of a taxpayer in whose name the book entry by the Reserve Bank is made, in a list of lot numbers with respect to all book-entry securities on the books of the Reserve Bank sold or transferred on that date by the taxpayer, provided such list is mailed to or received by the Reserve Bank on or before the Reserve Bank's next business day.

This subdivision shall apply only if the taxpayer assigns lot numbers in numerical sequence to successive purchases of securities of the same loan title (series) and maturity date, except that securities of the same loan title (series) and maturity date which are purchased at the same price on the same date may be included within the same lot.

(ii) In applying paragraph (c)(3)(i)(*b*) of this section to a sale or transfer of a book-entry security pursuant to a taxpayer's written instruction, a confirmation is made by furnishing to the taxpayer a written advice of transaction from the Reserve Bank or other person through whom the taxpayer sells or transfers the securities. The confirmation document must describe the securities and specify the date of

the transaction and amount of securities sold or transferred.

(iii) For purposes of this paragraph (c)(7):

(*a*) The term *book-entry security* means a transferable Treasury bond, note, certificate of indebtedness, or bill issued under the Second Liberty Bond Act (31 U.S.C. 774(2)), as amended, or other security of the United States (as defined in paragraph (c)(7)(iii)(*b*) of this section) in the form of an entry made as prescribed in 31 CFR Part 306, or other comparable Federal regulations, on the records of a Reserve Bank.

(*b*) The term *other security of the United States* means a bond, note, certificate of indebtedness, bill, debenture, or similar obligation which is subject to the provisions of 31 CFR part 306 or other comparable Federal regulations and which is issued by (*1*) any department or agency of the Government of the United States, or (*2*) the Federal National Mortgage Association, the Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation, the Federal Land Banks, the Federal Intermediate Credit Banks, the Banks for Cooperatives, or the Tennessee Valley Authority;

(*c*) The term *serially-numbered advice of transaction* means the confirmation (prescribed in 31 CFR 306.116) issued by the Reserve Bank which is identifiable by a unique number and indicates that a particular written instruction to the Reserve Bank with respect to the deposit or withdrawal of a specified book-entry security (or securities) has been executed; and

(*d*) The term *Reserve Bank* means a Federal Reserve Bank and its branches acting as Fiscal Agent of the United States.

(8) *Time for making identification*. For purposes of this paragraph (c), an adequate identification of stock is made at the time of sale, transfer, delivery, or distribution if the identification is made no later than the earlier of the settlement date or the time for settlement required by Rule 15c6–1 under the Securities Exchange Act of 1934, 17 CFR 240.15c6–1 (or its successor). A standing order or instruction for the specific identification of stock is treated as an adequate identification made at the time of sale, transfer, delivery, or distribution.

(9) *Method of writing*. (i) A written confirmation, record, document, instruction, notification, or advice includes a writing in electronic format.

(ii) A broker or agent may include the written confirmation required under this paragraph (c) in an account statement or other document the broker or agent periodically provides to the taxpayer if the broker or agent provides the statement or other document within a reasonable time after the sale or transfer.

(10) *Method for determining basis of stock*. A method of determining the basis of stock, including a method of identifying stock sold under this paragraph (c) and the average basis method described in paragraph (e) of this section, is not a method of accounting. Therefore, a change in a method of determining the basis of stock is not a change in method of accounting to which sections 446 and 481 apply.

(11) *Effective/applicability date*. Paragraphs (c)(1), (c)(4), (c)(6), (c)(7)(ii), (c)(7)(iii)(*a*), (c)(8), (c)(9), and (c)(10) of this section apply for taxable years beginning after October 18, 2010.

(d) *Obligations issued as part of an investment unit*. For purposes of determining the basis of the individual elements of an investment unit (as defined in paragraph (b)(2)(ii)(*a*) of § 1.1232–3) consisting of an obligation and an option (which is not an excluded option under paragraph (b)(1)(iii)(*c*) of § 1.1232–3), security, or other property, the cost of such investment unit shall be allocated to such individual elements on the basis of their respective fair market values. In the case of the initial issuance of an investment unit consisting of an obligation and an option, security, or other property, where neither the obligation nor the option, security, or other property has a readily ascertainable fair market value, the portion of the cost of the unit which is allocable to the obligation shall be an amount equal to the issue price of the obligation as determined under paragraph (b)(2)(ii)(*a*) of § 1.1232–3.

(e) *Election to use average basis method*—(1) *In general*. Notwithstanding paragraph (c) of this section, and except as provided in paragraph (e)(8) of

this section, a taxpayer may use the average basis method described in paragraph (e)(7) of this section to determine the cost or other basis of identical shares of stock if—

(i) The taxpayer leaves shares of stock in a regulated investment company (as defined in paragraph (e)(5) of this section) or shares of stock acquired after December 31, 2010, in connection with a dividend reinvestment plan (as defined in paragraph (e)(6) of this section) with a custodian or agent in an account maintained for the acquisition or redemption, sale, or other disposition of shares of the stock; and

(ii) The taxpayer acquires identical shares of stock at different prices or bases in the account.

(2) *Determination of method.* (i) If a taxpayer places shares of stock described in paragraph (e)(1)(i) of this section acquired on or after January 1, 2012, in the custody of a broker (as defined by section 6045(c)(1)), including by transfer from an account with another broker, the basis of the shares is determined in accordance with the broker's default method, unless the taxpayer notifies the broker that the taxpayer elects another permitted method. The taxpayer must report gain or loss using the method the taxpayer elects or, if the taxpayer fails to make an election, the broker's default method. *See* paragraphs (e)(9)(i) and (e)(9)(v), *Example 2,* of this section.

(ii) The provisions of this paragraph (e)(2) are illustrated by the following example:

Example. (i) In connection with a dividend reinvestment plan, Taxpayer B acquires 100 shares of G Company in 2012 and 100 shares of G Company in 2013, in an account B maintains with R Broker. B notifies R in writing that B elects to use the average basis method to compute the basis of the shares of G Company. In 2014, B transfers the shares of G Company to an account with S Broker. B does not notify S of the basis determination method B chooses to use for the shares of G Company, and S's default method is first-in, first-out. In 2015, B purchases 200 shares of G Company in the account with S. In 2016, B instructs S to sell 150 shares of G Company.

(ii) Because B does not notify S of a basis determination method for the shares of G Company, under paragraph (e)(2)(i) of this section, the basis of the 150 shares of G Company S sells for B in 2016 must be determined under S's default method, first-in, first-out.

(3) *Shares of stock.* For purposes of this paragraph (e), securities issued by unit investment trusts described in paragraph (e)(5) of this section are treated as shares of stock and the term *share* or *shares* includes fractions of a share.

(4) *Identical stock.* For purposes of this paragraph (e), *identical shares of stock* means stock with the same Committee on Uniform Security Identification Procedures (CUSIP) number or other security identifier number as permitted in published guidance of general applicability, *see* §601.601(d)(2) of this chapter.

(5) *Regulated investment company.* (i) For purposes of this paragraph, a *regulated investment company* means any domestic corporation (other than a personal holding company as defined in section 542) which meets the limitations of section 851(b) and §1.851–2, and which is registered at all times during the taxable year under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1 to 80b–2), either as a management company, or as a unit investment trust.

(ii) Notwithstanding subdivision (i), this paragraph shall not apply in the case of a unit investment trust unless it is one—

(*a*) Substantially all of the assets of which consist (*1*) of securities issued by a single management company (as defined in such Act) and securities acquired pursuant to subdivision (*b*) of this subdivision (ii), or (*2*) securities issued by a single other corporation, and

(*b*) Which has no power to invest in any other securities except securities issued by a single other management company, when permitted by such Act or the rules and regulations of the Securities and Exchange Commission.

(6) *Dividend reinvestment plan*—(i) *In general.* For purposes of this paragraph (e), the term *dividend reinvestment plan* means any written plan, arrangement, or program under which at least 10 percent of every dividend (within the meaning of section 316) on any share of stock is reinvested in stock identical to the stock on which the dividend is paid. A plan is a dividend reinvestment plan if the plan documents require that at least 10 percent of any dividend paid

is reinvested in identical stock even if the plan includes stock on which no dividends have ever been declared or paid or on which an issuer ceases paying dividends. A plan that holds one or more different stocks may permit a taxpayer to reinvest a different percentage of dividends in the stocks held. A dividend reinvestment plan may reinvest other distributions on stock, such as capital gain distributions, nontaxable returns of capital, and cash in lieu of fractional shares. The term dividend reinvestment plan includes both issuer administered dividend reinvestment plans and non-issuer administered dividend reinvestment plans.

(ii) *Acquisition of stock.* Stock is acquired in connection with a dividend reinvestment plan if the stock is acquired under that plan, arrangement, or program, or if the dividends and other distributions paid on the stock are subject to that plan, arrangement, or program. Shares of stock acquired in connection with a dividend reinvestment plan include the initial purchase of stock in the dividend reinvestment plan, transfers of identical stock into the dividend reinvestment plan, additional periodic purchases of identical stock in the dividend reinvestment plan, and identical stock acquired through reinvestment of the dividends or other distributions paid on the stock held in the plan.

(iii) *Dividends and other distributions paid after reorganization.* For purposes of this paragraph (e)(6), dividends and other distributions declared or announced before or pending a corporate action (such as a merger, consolidation, acquisition, split-off, or spin-off) involving the issuer and subsequently paid and reinvested in shares of stock in the successor entity or entities are treated as reinvested in shares of stock identical to the shares of stock of the issuer.

(iv) *Withdrawal from or termination of plan.* If a taxpayer withdraws stock from a dividend reinvestment plan or the plan administrator terminates the dividend reinvestment plan, the shares of identical stock the taxpayer acquires after the withdrawal or termination are not acquired in connection with a dividend reinvestment plan. The taxpayer may not use the average basis method after the withdrawal or termination but may use any other permissible basis determination method. See paragraph (e)(7)(v) of this section for the basis of the shares after withdrawal or termination.

(7) *Computation of average basis*—(i) *In general.* Average basis is determined by averaging the basis of all shares of identical stock in an account regardless of holding period. However, for this purpose, shares of stock in a dividend reinvestment plan are not identical to shares of stock with the same CUSIP number that are not in a dividend reinvestment plan. The basis of each share of identical stock in the account is the aggregate basis of all shares of that stock in the account divided by the aggregate number of shares. Unless a single-account election is in effect, see paragraph (e)(11) of this section, a taxpayer may not average together the basis of identical stock held in separate accounts that the taxpayer sells, exchanges, or otherwise disposes of on or after January 1, 2012.

(ii) *Order of disposition of shares sold or transferred.* In the case of the sale or transfer of shares of stock to which the average basis method election applies, shares sold or transferred are deemed to be the shares first acquired. Thus, the first shares sold or transferred are those with a holding period of more than 1 year (long-term shares) to the extent that the account contains long-term shares. If the number of shares sold or transferred exceeds the number of long-term shares in the account, the excess shares sold or transferred are deemed to be shares with a holding period of 1 year or less (short-term shares). Any gain or loss attributable to shares held for more than 1 year constitutes long-term gain or loss, and any gain or loss attributable to shares held for 1 year or less constitutes short-term gain or loss. For example, if a taxpayer sells 50 shares from an account containing 100 long-term shares and 100 short-term shares, the shares sold or transferred are all long-term shares. If, however, the account contains 40 long-term shares and 100 short-term shares, the taxpayer has sold 40 long-term shares and 10 short-term shares.

(iii) *Transition rule from double-category method.* This paragraph (e)(7)(iii) applies to stock for which a taxpayer uses the double-category method under § 1.1012–1(e)(3) (April 1, 2010), that the taxpayer acquired before April 1, 2011, and that the taxpayer sells, exchanges, or otherwise disposes of on or after that date. The taxpayer must calculate the average basis of this stock by averaging together all identical shares of stock in the account on April 1, 2011, regardless of holding period.

(iv) *Wash sales.* A taxpayer must apply section 1091 and the associated regulations (dealing with wash sales of substantially identical securities) in computing average basis regardless of whether the stock or security sold or otherwise disposed of and the stock acquired are in the same account or in different accounts.

(v) *Basis after change from average basis method.* Unless a taxpayer revokes an average basis method election under paragraph (e)(9)(iii) of this section, if a taxpayer changes from the average basis method to another basis determination method (including a change resulting from a withdrawal from or termination of a dividend reinvestment plan), the basis of each share of stock immediately after the change is the same as the basis immediately before the change. *See* paragraph (e)(9)(iv) of this section for rules for changing from the average basis method.

(vi) The provisions of this paragraph (e)(7) are illustrated by the following examples:

Example 1. (i) In 2011, Taxpayer C acquires 100 shares of H Company and enrolls them in a dividend reinvestment plan administered by T Custodian. C elects to use the average basis method for the shares of H Company enrolled in the dividend reinvestment plan. T also acquires for C's account 50 shares of H Company and does not enroll these shares in the dividend reinvestment plan.

(ii) Under paragraph (e)(7)(i) of this section, the 50 shares of H Company not in the dividend reinvestment plan are not identical to the 100 shares of H Company enrolled in the dividend reinvestment plan, even if they have the same CUSIP number. Accordingly, under paragraphs (e)(1) and (e)(7)(i) of this section, C may not average the basis of the 50 shares of H Company with the basis of the 100 shares of H Company. Under paragraph (e)(1)(i) of this section, C may not use the average basis method for the 50 shares of H Company because the shares are not acquired in connection with a dividend reinvestment plan.

Example 2. (i) Taxpayer D enters into an agreement with W Custodian establishing an account for the periodic acquisition of shares of L Company, a regulated investment company. W acquires for D's account shares of L Company stock on the following dates and amounts:

Date	Number of shares	Cost
January 8, 2010	25	$200
February 8, 2010	24	200
March 8, 2010	20	200
April 8, 2010	20	200

(ii) At D's direction, W sells 40 shares from the account on January 15, 2011, for $10 per share or a total of $400. D elects to use the average basis method for the shares of L Company. The average basis for the shares sold on January 15, 2011, is $8.99 (total cost of shares, $800, divided by the total number of shares, 89).

(iii) Under paragraph (e)(7)(ii) of this section, the shares sold are the shares first acquired. Thus, D realizes $25.25 ($1.01 * 25) long-term capital gain for the 25 shares acquired on January 8, 2010, and $15.15 ($1.01 * 15) short-term capital gain for 15 of the shares acquired on February 8, 2010.

Example 3. (i) The facts are the same as in *Example 2,* except that on February 8, 2011, D changes to the first-in, first-out basis determination method. W purchases 25 shares of L Company for D on March 8, 2011, at $12 per share. D sells 40 shares on May 8, 2011, and 34 shares on July 8, 2012.

(ii) Because D uses the first-in, first-out method, the 40 shares sold on May 8, 2011 are 9 shares purchased on February 8, 2010, 20 shares purchased on March 8, 2010, and 11 shares purchased on April 8, 2010. Because, under paragraph (e)(7)(v) of this section, the basis of the shares D owns when D changes from the average basis method remains the same, the basis of the shares sold on May 8, 2011, is $8.99 per share, not the original cost of $8.33 per share for the shares purchased on February 8, 2010, or $10 per share for the shares purchased on March 8, 2010, and April 8, 2010. The basis of the shares sold on July 8, 2012, is $8.99 per share for 9 shares purchased on April 8, 2010, and $12 per share for 25 shares purchased on March 8, 2011.

Example 4. (i) The facts are the same as in *Example 2,* except that D uses the first-in, first-out method for the 40 shares sold on January 15, 2011. W purchases 25 shares of L Company for D on March 8, 2011, at $12 per share. D sells 40 shares on May 8, 2011, and elects the average basis method.

(ii) Because D uses the first-in, first-out method for the sale on January 15, 2011, the 40 shares sold are the 25 shares acquired on

January 8, 2010, for $200 (basis $8 per share) and 15 of the 24 shares purchased on February 8, 2010, for $200 (basis $8.33 per share).

(iii) Under paragraph (e)(7)(i) of this section, under the average basis method, the basis of all of the shares of identical stock in D's account is averaged. Thus, the basis of each share D sells on May 8, 2011, after electing the average basis method, is $10.47. This figure is the total cost of the shares in D's account ($74.97 for the 9 shares acquired on February 8, 2010, $200 for the 20 shares acquired on March 8, 2010, $200 for the 20 shares acquired on April 8, 2010, and $300 for the 25 shares acquired on March 8, 2011) divided by 74, the total number of shares ($774.97/74).

(8) *Limitation on use of average basis method for certain gift shares.* (i) Except as provided in paragraph (e)(8)(ii) of this section, a taxpayer may not use the average basis method for shares of stock a taxpayer acquires by gift after December 31, 1920, if the basis of the shares (adjusted for the period before the date of the gift as provided in section 1016) in the hands of the donor or the last preceding owner by whom the shares were not acquired by gift was greater than the fair market value of the shares at the time of the gift. This paragraph (e)(8)(i) does not apply to shares the taxpayer acquires as a result of a taxable dividend or capital gain distribution on the gift shares.

(ii) Notwithstanding paragraph (e)(8)(i) of this section, a taxpayer may use the average basis method if the taxpayer states in writing that the taxpayer will treat the basis of the gift shares as the fair market value of the shares at the time the taxpayer acquires the shares. The taxpayer must provide this statement when the taxpayer makes the election under paragraph (e)(9) of this section or when transferring the shares to an account for which the taxpayer has made this election, whichever occurs later. The statement must be effective for any gift shares identical to the gift shares to which the average basis method election applies that the taxpayer acquires at any time and must remain in effect as long as the election remains in effect.

(iii) The provisions of this paragraph (e)(8) are illustrated by the following examples:

Example 1. (i) Taxpayer E owns an account for the periodic acquisition of shares of M Company, a regulated investment company. On April 15, 2010, E acquires identical shares of M Company by gift and transfers those shares into the account. These shares had an adjusted basis in the hands of the donor that was greater than the fair market value of the shares on that date. On June 15, 2010, E sells shares from the account and elects to use the average basis method.

(ii) Under paragraph (e)(8)(ii) of this section, E may elect to use the average basis method for shares sold or transferred from the account if E includes a statement with E's election that E will treat the basis of the gift shares in the account as the fair market value of the shares at the time E acquired them. *See* paragraph (e)(9)(ii) of this section.

Example 2. (i) The facts are the same as in *Example 1*, except E acquires the gift shares on April 15, 2012, transfers those shares into the account, and used the average basis method for sales of shares of M Company before acquiring the gift shares. E sells shares of M Company on June 15, 2012.

(ii) Under paragraph (e)(8)(ii) of this section, the basis of the gift shares may be averaged with the basis of the other shares of M Company in E's account if, when E transfers the gift shares to the account, E provides a statement to E's broker that E will treat the basis of the gift shares in the account as the fair market value of the shares at the time E acquired them. *See* paragraph (e)(9)(i) of this section.

(9) *Time and manner for making the average basis method election*—(i) *In general.* A taxpayer makes an election to use the average basis method for shares of stock described in paragraph (e)(1)(i) of this section that are covered securities (within the meaning of section 6045(g)(3)) by notifying the custodian or agent in writing by any reasonable means. For purposes of this paragraph (e), a writing may be in electronic format. A taxpayer has not made an election within the meaning of this section if the taxpayer fails to notify a broker of the taxpayer's basis determination method and basis is determined by the broker's default method under paragraph (e)(2) of this section. A taxpayer may make the average basis method election at any time, effective for sales or other dispositions of stock occurring after the taxpayer notifies the custodian or agent. The election must identify each account with that custodian or agent and each stock in that account to which the election applies. The election may specify that it applies to all accounts with a custodian

or agent, including accounts the taxpayer later establishes with the custodian or agent. If the election applies to gift shares, the taxpayer must provide the statement required by paragraph (e)(8)(ii) of this section, if applicable, to the custodian or agent with the taxpayer's election.

(ii) *Average basis method election for securities that are noncovered securities.* A taxpayer makes an election to use the average basis method for shares of stock described in paragraph (e)(1)(i) of this section that are noncovered securities (as described in §1.6045–1(a)(16)) on the taxpayer's income tax return for the first taxable year for which the election applies. A taxpayer may make the election on an amended return filed no later than the time prescribed (including extensions) for filing the original return for the taxable year for which the election applies. The taxpayer must indicate on the return that the taxpayer used the average basis method in reporting gain or loss on the sale or other disposition. A taxpayer must attach to the return the statement described in paragraph (e)(8)(ii) of this section, if applicable. A taxpayer making the election must maintain records necessary to substantiate the average basis reported.

(iii) *Revocation of election.* A taxpayer may revoke an election under paragraph (e)(9)(i) of this section by the earlier of one year after the taxpayer makes the election or the date of the first sale, transfer, or disposition of that stock following the election. A custodian or agent may extend the one-year period but a taxpayer may not revoke an election after the first sale, transfer, or disposition of the stock. A revocation applies to all stock the taxpayer holds in an account that is identical to the shares of stock for which the taxpayer revokes the election. A revocation is effective when the taxpayer notifies, in writing by any reasonable means, the custodian or agent holding the stock to which the revocation applies. After revocation, the taxpayer's basis in the shares of stock to which the revocation applies is the basis before averaging.

(iv) *Change from average basis method.* A taxpayer may change basis determination methods from the average basis method to another method prospectively at any time. A change from the average basis method applies to all identical stock the taxpayer sells or otherwise disposes of before January 1, 2012, that was held in any account. A change from the average basis method applies on an account by account basis (within the meaning of paragraph (e)(10) of this section) to all identical stock the taxpayer sells or otherwise disposes of on or after January 1, 2012. The taxpayer must notify, in writing by any reasonable means, the custodian or agent holding the stock to which the change applies. Unless paragraph (e)(9)(iii) of this section applies, the basis of each share of stock to which the change applies remains the same as the basis immediately before the change. *See* paragraph (e)(7)(v) of this section.

(v) *Examples.* The provisions of this paragraph (e)(9) are illustrated by the following examples:

Example 1. (i) Taxpayer F enters into an agreement with W Custodian establishing an account for the periodic acquisition of shares of N Company, a regulated investment company. W acquires for F's account shares of N Company on the following dates and amounts:

Date	Number of shares	Cost
January 8, 2012	25	$200
February 8, 2012	24	200
March 8, 2012	20	200

(ii) F notifies W that F elects, under paragraph (e)(9)(i) of this section, to use the average basis method for the shares of N Company. On May 8, 2012, under paragraph (e)(9)(iii) of this section, F notifies W that F revokes the average basis method election. On June 1, 2012, F sells 60 shares of N Company using the first-in, first-out basis determination method.

(iii) Under paragraph (e)(9)(iii) of this section, the basis of the N Company shares upon revocation, and for purposes of determining gain on the sale, is $8.00 per share for each of the 25 shares purchased on January 8, 2012, $8.34 per share for each of the 24 shares purchased on February 8, 2012, and $10 per share for the remaining 11 shares purchased on March 8, 2012.

Example 2. (i) The facts are the same as in *Example 1*, except that F does not notify W that F elects a basis determination method. W's default basis determination method is the average basis method and W maintains

an averaged basis for F's shares of N Company on W's books and records.

(ii) F has not elected the average basis method under paragraph (e)(9)(i) of this section. Therefore, F's notification to W on May 8, 2012, is not an effective revocation under paragraph (e)(9)(iii) of this section. F's attempted revocation is, instead, notification of a change from the average basis method under paragraph (e)(9)(iv) of this section. Accordingly, the basis of each share of stock F sells on June 1, 2012, is the basis immediately before the change, $8.70 (total cost of shares, $600, divided by the total number of shares, 69).

(10) *Application of average basis method account by account*—(i) *In general*. For sales, exchanges, or other dispositions on or after January 1, 2012, of stock described in paragraph (e)(1)(i) of this section, the average basis method applies on an account by account basis. A taxpayer may use the average basis method for stock in a regulated investment company or stock acquired in connection with a dividend reinvestment plan in one account but use a different basis determination method for identical stock in a different account. If a taxpayer uses the average basis method for a stock described in paragraph (e)(1)(i) of this section, the taxpayer must use the average basis method for all identical stock within that account. The taxpayer may use different basis determination methods for stock within an account that is not identical. Except as provided in paragraph (e)(10)(ii) of this section, a taxpayer must make separate elections to use the average basis method for stock held in separate accounts.

(ii) *Account rule for stock sold before 2012*. A taxpayer's election to use the average basis method for shares of stock described in paragraph (e)(1)(i) of this section that a taxpayer sells, exchanges, or otherwise disposes of before January 1, 2012, applies to all identical shares of stock the taxpayer holds in any account.

(iii) *Separate account*. Unless the single-account election described in paragraph (e)(11)(i) of this section applies, stock described in paragraph (e)(1)(i) of this section that is a covered security (within the meaning of section 6045(g)(3)) is treated as held in a separate account from stock that is a noncovered security (as described in §1.6045–1(a)(16)), regardless of when acquired.

(iv) *Examples*. The provisions of this paragraph (e)(10) are illustrated by the following examples:

Example 1. (i) In 2012, Taxpayer G enters into an agreement with Y Broker establishing three accounts (G–1, G–2, and G–3) for the periodic acquisition of shares of P Company, a regulated investment company. Y makes periodic purchases of P Company for each of G's accounts. G elects to use the average basis method for account G–1. On July 1, 2013, G sells shares of P Company from account G–1.

(ii) G is not required to use the average basis method for the shares of P Company that G holds in accounts G–2 and G–3 because, under paragraph (e)(10)(i) of this section, the average basis method election applies to shares sold after 2011 on an account by account basis.

Example 2. The facts are the same as in *Example 1*, except that G also instructs Y to acquire shares of Q Company, a regulated investment company, for account G–1. Under paragraph (e)(10)(i) of this section, G may use any permissible basis determination method for the shares of Q Company because, under paragraph (e)(4) of this section, the shares of Q Company are not identical to the shares of P Company.

Example 3. (i) The facts are the same as in *Example 1*, except that G establishes the accounts in 2011 and Y sells shares of P Company from account G–1 on July 1, 2011.

(ii) For sales before 2012, under paragraph (e)(10)(ii) of this section, G's election applies to all accounts in which G holds identical stock. G must average together the basis of the shares in all accounts to determine the basis of the shares sold from account G–1.

Example 4. (i) In 2011, Taxpayer H acquires 80 shares of R Company and enrolls them in R Company's dividend reinvestment plan. In 2012, H acquires 50 shares of R Company in the dividend reinvestment plan. H elects to use the average basis method for the shares of R Company in the dividend reinvestment plan. R Company does not make the single-account election under paragraph (e)(11)(i) of this section.

(ii) Under section 6045(g)(3) and §1.6045–1(a)(16), the 80 shares acquired in 2011 are noncovered securities and the 50 shares acquired in 2012 are covered securities. Therefore, under paragraph (e)(10)(iii) of this section, the 80 shares are treated as held in a separate account from the 50 shares. H must make a separate average basis method election for each account and must average the basis of the shares in each account separately from the shares in the other account.

Example 5. (i) B Broker maintains an account for Taxpayer J for the periodic acquisition of shares of S Company, a regulated

investment company. In 2013, B purchases shares of S Company for J's account that are covered securities within the meaning of section 6045(g)(3). On April 15, 2014, J inherits shares of S Company that are noncovered securities and transfers the shares into the account with B.

(ii) Under paragraph (e)(10)(iii) of this section, J must treat the purchased shares and the inherited shares of S Company as held in separate accounts. J may elect to apply the average basis method to all the shares of S Company, but must make a separate election for each account, and must average the basis of the shares in each account separately from the shares in the other account.

Example 6. (i) In 2010, Taxpayer K purchases stock in T Company in an account with C Broker. In 2012, K purchases additional T Company stock and enrolls that stock in a dividend reinvestment plan maintained by C. K elects the average basis method for the T Company stock. In 2013, K transfers the T Company stock purchased in 2010 into the dividend reinvestment plan.

(ii) Under paragraphs (e)(1)(i) and (e)(6)(ii) of this section, the stock purchased in 2010 is not stock acquired after December 31, 2010, in connection with a dividend reinvestment plan before transfer into the dividend reinvestment plan. Therefore, the stock is not eligible for the average basis method at that time.

(iii) Once transferred into the dividend reinvestment plan in 2013, the stock K purchased in 2010 is acquired after December 31, 2010, in connection with a dividend reinvestment plan within the meaning of paragraph (e)(6)(ii) of this section and is eligible for the average basis method. Because stock purchased in 2010 is a noncovered security under § 1.6045–1(a)(16), under paragraph (e)(10)(iii) of this section, the 2010 stock and the 2012 stock must be treated as held in separate accounts. Under paragraph (e)(7)(i) of this section, the basis of the 2010 shares may not be averaged with the basis of the 2012 shares.

Example 7. The facts are the same as in *Example 6*, except that K purchases the initial T Company stock in January 2011. Because this stock is a covered security under section 6045(g)(3) and § 1.6045–1(a)(15)(iv)(A), the 2011 stock and the 2012 stock are not required under paragraph (e)(10)(iii) of this section to be treated as held in separate accounts. Under paragraph (e)(7)(i) of this section, the basis of the 2011 shares must be averaged with the basis of the 2012 shares.

Example 8. (i) The facts are the same as in *Example 7*, except that K purchases the additional T Company stock and enrolls in the dividend reinvestment plan in March 2011. In September 2011, K transfers the T Company stock purchased in January 2011 into the dividend reinvestment plan. K sells some of the T Company stock in 2012.

(ii) Under section 6045(g)(3) and § 1.6045–1(a)(16), the stock K purchases in January 2011 is a covered security at the time of purchase but the stock K purchases and enrolls in the dividend reinvestment plan in March 2011 is a noncovered security. However, under § 1.6045–1(a)(15)(iv)(A), the stock purchased in January 2011 becomes a noncovered security after it is transferred to the dividend reinvestment plan. Because all the shares in the dividend reinvestment plan in September 2011 are noncovered securities, when K sells stock in 2012, the January 2011 stock and the March 2011 stock are not required under paragraph (e)(10)(iii) of this section to be treated as held in separate accounts. Under paragraph (e)(7)(i) of this section, the basis of the January 2011 shares must be averaged with the basis of the March 2011 shares.

(11) *Single-account election*—(i) *In general*. Paragraph (e)(10)(iii) of this section does not apply if a regulated investment company or dividend reinvestment plan elects to treat all identical shares of stock described in paragraph (e)(1)(i) of this section as held in a single account (single-account election). The single-account election applies only to stock for which a taxpayer elects to use the average basis method that is held in separate accounts or treated as held in separate accounts maintained for the taxpayer and only to accounts with the same ownership. If a broker (as defined by section 6045(c)(1)) holds the stock as a nominee, the broker, and not the regulated investment company or dividend reinvestment plan, makes the election. The single-account election is irrevocable, but is void if the taxpayer revokes the average basis election under paragraph (e)(9)(iii) of this section.

(ii) *Scope of election*. A company, plan, or broker may make a single-account election for one or more taxpayers for which it maintains an account, and for one or more stocks it holds for a taxpayer. The company, plan, or broker may make the election only for the shares of stock for which it has accurate basis information. A company, plan, or broker has accurate basis information if the company, plan, or broker neither knows nor has reason to know that the basis information is inaccurate. *See* also section 6724 and the associated regulations regarding standards for relief from information reporting penalties. Stock for which accurate

basis information is unavailable may not be included in the single-account election and must be treated as held in a separate account.

(iii) *Effect of single-account election.* If a company, plan, or broker makes the single-account election, the basis of all identical shares of stock to which the election applies must be averaged together regardless of when the taxpayer acquires the shares, and all the shares are treated as covered securities. The single-account election applies to all identical stock a taxpayer later acquires in the account that is a covered security (within the meaning of section 6045(g)(3)). A company, plan, or broker may make another single-account election if, for example, the broker later acquires accurate basis information for a stock, or a taxpayer acquires identical stock in the account that is a noncovered security (as described in § 1.6045–1(a)(16)) for which the company, plan, or broker has accurate basis information.

(iv) *Time and manner for making the single-account election.* A company, plan, or broker makes the single-account election by clearly noting it on its books and records. The books and records must reflect the date of the election; the taxpayer's name, account number, and taxpayer identification number; the stock subject to the election; and the taxpayer's basis in the stock. The company, plan, or broker must provide copies of the books and records regarding the election to the taxpayer upon request. A company, plan, or broker may make the single-account election at any time.

(v) *Notification to taxpayer.* A company, plan, or broker making the single-account election must use reasonable means to notify the taxpayer of the election. Reasonable means include mailings, circulars, or electronic mail sent separately to the taxpayer or included with the taxpayer's account statement, or other means reasonably calculated to provide actual notice to the taxpayer. The notice must identify the securities subject to the election and advise the taxpayer that the securities will be treated as covered securities regardless of when acquired.

(vi) *Examples.* The provisions of this paragraph (e)(11) are illustrated by the following examples:

Example 1. (i) E Broker maintains Accounts A and B for Taxpayer M for the acquisition and disposition of shares of T Company, a regulated investment company. In 2011, E purchases 100 shares of T Company for M's Account A. E has accurate basis information for these shares. In 2012, E purchases 150 shares of T Company for M's Account A and 80 shares of T Company for M's Account B. M elects to use the average basis method for all shares of T Company. E makes a single-account election for M's T Company stock.

(ii) The shares of T Company in Accounts A and B are held in separate accounts. Under section 6045(g)(3) and § 1.6045–1(a)(16), of the shares purchased in Account A, the 100 shares purchased in 2011 are noncovered securities and the 150 shares purchased in 2012 are covered securities. Under paragraph (e)(10)(iii) of this section, the 100 shares are treated as held in a separate account from the 150 shares. Under paragraph (e)(11)(i) of this section, the single-account election applies to all 330 shares of T Company in Accounts A and B. Thus, under paragraph (e)(11)(iii) of this section, the basis of the 330 shares of stock is averaged together and all the shares are treated as covered securities.

Example 2. The facts are the same as in *Example 1*, except that M owns Account B jointly with Taxpayer N. E may make a single-account election for the 250 shares of stock in M's Account A. However, under paragraph (e)(11)(i) of this section, E may not make a single-account election for Accounts A and B because the accounts do not have the same ownership.

Example 3. (i) C Broker maintains an account for Taxpayer K for the acquisition and disposition of shares of T Company, a regulated investment company, and shares of V Company that K enrolls in C's dividend reinvestment plan. In 2011, C purchases for K's account 100 shares of T Company in multiple lots and 80 shares of V Company in multiple lots that are enrolled in the dividend reinvestment plan. C has accurate basis information for all 100 shares of T Company and 80 shares of V Company. In 2012, C acquires for K's account 150 shares of T Company and 160 shares of V Company that are enrolled in the dividend reinvestment plan. K elects to use the average basis method for all the shares of T Company and V Company.

(ii) Under paragraphs (e)(11)(i) and (ii) of this section, C may make a single-account election for the T Company stock or the V Company stock, or both. After making a single-account election for each stock, under paragraph (e)(11)(iii) of this section, the basis of all T Company stock is averaged together and the basis of all V Company stock

is averaged together, regardless of when acquired, and all the shares of T Company and V Company are treated as covered securities.

Example 4. The facts are the same as in *Example 3*, except that K transfers the 100 shares of T Company acquired in 2011 from an account with another broker into K's account with C. C does not have accurate basis information for 30 of the 100 shares of T Company, which K had acquired in two lots. Under paragraph (e)(11)(ii) of this section, C may make the single-account election only for the 70 shares of T Company stock for which C has accurate basis information. C must treat the 30 shares of T Company for which C does not have accurate basis information as held in a separate account. K may use the average basis method for the 30 shares of T Company, but must make a separate average basis method election for these shares and must average the basis of these shares separately from the 70 shares subject to C's single-account election.

Example 5. The facts are the same as in *Example 3*, except that C has made the single-account election and in 2013 K acquires additional shares of T Company that are covered securities in K's account with C. Under paragraph (e)(11)(iii) of this section, these shares of T Company are subject to C's single-account election.

Example 6. The facts are the same as in *Example 3*, except that C has made the single-account election and in 2013 K inherits shares of T Company that are noncovered securities and transfers the shares into the account with C. C has accurate basis information for these shares. Under paragraph (e)(11)(iii) of this section, C may make a second single-account election to include the inherited T Company shares.

Example 7. (i) Between 2002 and 2011, Taxpayer L acquires 1,500 shares of W Company, a regulated investment company, in an account with D Broker, for which L uses the average basis method, and sells 500 shares. On January 5, 2012, based on accurate basis information, the averaged basis of L's remaining 1,000 shares of W Company is $24 per share. On January 5, 2012, L acquires 100 shares of W Company for $28 per share and makes an average basis election for those shares under paragraph (e)(9)(i) of this section.

(ii) On February 1, 2012, D makes a single-account election that includes all 1,100 of L's shares in W Company. Thereafter, the basis of L's shares of W Company is $24.36 per share (($24,000 + $2,800)/1,100). On September 12, 2012, under paragraph (e)(9)(iii) of this section, L revokes the average basis election for the 100 shares acquired on January 5, 2012.

(iii) Under paragraph (e)(11)(i) of this section, D's single-account election is void. Therefore, the basis of the 1,000 shares of W Company that L acquires before 2012 is $24 per share and the basis of the 100 shares of W Company that L acquires in 2012 is $28 per share.

(12) *Effective/applicability date*. Except as otherwise provided in paragraphs (e)(1), (e)(2), (e)(7), (e)(9), and (e)(10) of this section, this paragraph (e) applies for taxable years beginning after October 18, 2010.

(f) *Special rules*. For special rules for determining the basis for gain or loss in the case of certain vessels acquired through the Maritime Commission (or its successors) or pursuant to an agreement with the Secretary of Commerce, see sections 510, 511, and 607 of the Merchant Marine Act, 1936, as amended (46 U.S.C. 1160, 1161) and parts 2 and 3 of this chapter. For special rules for determining the unadjusted basis of property recovered in respect of war losses, see section 1336. For special rules with respect to taxable years beginning before January 1, 1964, for determining the basis for gain or loss in the case of a disposition of a share of stock acquired pursuant to the timely exercise of a restricted stock option where the option price was between 85 percent and 95 percent of the fair market value of the stock at the time the option was granted, see paragraph (b) of §1.421–5. See section 423(c)(1) or 424(c)(1), whichever is applicable, for special rules with respect to taxable years ending after December 31, 1963, for determining the basis for gain or loss in the case of the disposition of a share of stock acquired pursuant to the timely exercise of a stock option described in such sections. See section 422(c)(1) for special rules with respect to taxable years ending after December 31, 1963, for determining the basis for gain or loss in the case of an exercise of a qualified stock option.

(g) *Debt instruments issued in exchange for property*—(1) *In general*. For purposes of paragraph (a) of this section, if a debt instrument is issued in exchange for property, the cost of the property that is attributable to the debt instrument is the issue price of the debt instrument as determined under §1.1273–2 or §1.1274–2, whichever is applicable. If, however, the issue price of the debt instrument is determined under section 1273(b)(4), the cost of the property attributable to the debt instrument is its

stated principal amount reduced by any unstated interest (as determined under section 483).

(2) *Certain tax-exempt obligations.* This paragraph (g)(2) applies to a tax-exempt obligation (as defined in section 1275(a)(3)) that is issued in exchange for property and that has an issue price determined under § 1.1274–2(j) (concerning tax-exempt contingent payment obligations and certain tax-exempt variable rate debt instruments subject to section 1274). Notwithstanding paragraph (g)(1) of this section, if this paragraph (g)(2) applies to a tax-exempt obligation, for purposes of paragraph (a) of this section, the cost of the property that is attributable to the obligation is the sum of the present values of the noncontingent payments (as determined under § 1.1274–2(c)).

(3) *Effective date.* This paragraph (g) applies to sales or exchanges that occur on or after August 13, 1996.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.1012–1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.govinfo.gov*.

§ 1.1012–2 Transfers in part a sale and in part a gift.

For rules relating to basis of property acquired in a transfer which is in part a gift and in part a sale, see §§ 1.170A–4(c), 1.1011–2(b), and § 1.105–4.

[T.D. 7207, 37 FR 20799, Oct. 5, 1972]

§ 1.1013–1 Property included in inventory.

The basis of property required to be included in inventory is the last inventory value of such property in the hands of the taxpayer. The requirements with respect to the valuation of an inventory are stated in subpart D (section 471 and following), part II, subchapter E, chapter 1 of the Code, and the regulations thereunder.

§ 1.1014–1 Basis of property acquired from a decedent.

(a) *General rule.* The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent that is equal to the value placed upon such property for purposes of the federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death, or, if the decedent's executor so elects, at the alternate valuation date prescribed in section 2032, or in section 811(j) of the Internal Revenue Code (Code) of 1939. However, the basis of property acquired from certain decedents who died in 2010 is determined under section 1022, if the decedent's executor made an election under section 301(c) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Public Law 111–312 (124 Stat. 3296, 3300 (2010)). See section 1022. Property acquired from a decedent includes, principally, property acquired by bequest, devise, or inheritance, and, in the case of decedents dying after December 31, 1953, property required to be included in determining the value of the decedent's gross estate under any provision of the Code of 1954 or the Code of 1939. The general rule governing basis of property acquired from a decedent, as well as other rules prescribed elsewhere in this section, shall have no application if the property is sold, exchanged, or otherwise disposed of before the decedent's death by the person who acquired the property from the decedent. For general rules on the applicable valuation date where the executor of a decedent's estate elects under section 2032, or under section 811(j) of the Code of 1939, to value the decedent's gross estate at the alternate valuation date prescribed in such sections, see § 1.1014–3(e).

(b) *Scope and application.* With certain limitations, the general rule described in paragraph (a) of this section is applicable to the classes of property described in paragraphs (a) and (b) of § 1.1014–2, including stock in a DISC or former DISC. In the case of stock in a DISC or former DISC, the provisions of this section and §§ 1.1014–2 through 1.1014–8 are applicable, except as provided in § 1.1014–9. Special basis rules with respect to the basis of certain other property acquired from a decedent are set forth in paragraph (c) of § 1.1014–2. These special rules concern certain stock or securities of a foreign

personal holding company and the surviving spouse's one-half share of community property held with a decedent dying after October 21, 1942, and on or before December 31, 1947. In this section and §§ 1.1014–2 to 1.1014–6, inclusive, whenever the words *property acquired from a decedent* are used, they shall also mean *property passed from a decedent*, and the phrase *person who acquired it from the decedent* shall include the *person to whom it passed from the decedent*.

(c) *Property to which section 1014 does not apply*. Section 1014 shall have no application to the following classes of property:

(1) Property which constitutes a right to receive an item of income in respect of a decedent under section 691; and

(2) Restricted stock options described in section 421 which the employee has not exercised at death if the employee died before January 1, 1957. In the case of employees dying after December 31, 1956, see paragraph (d)(4) of § 1.421–5. In the case of employees dying in a taxable year ending after December 31, 1963, see paragraph (c)(4) of § 1.421–8 with respect to an option described in part II of subchapter D.

(d) *Effective/applicability date*. This section applies on and after January 19, 2017. For rules before January 19, 2017, see § 1.1014–1 as contained in 26 CFR part 1 revised as of April 1, 2016.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 413, Jan. 19, 1961; T.D. 6887, 31 FR 8812, June 24, 1966; T.D. 7283, 38 FR 20825, Aug. 3, 1973; T.D. 9811, 82 FR 6240, Jan. 19, 2017]

§ 1.1014–2 Property acquired from a decedent.

(a) *In general*. The following property, except where otherwise indicated, is considered to have been acquired from a decedent and the basis thereof is determined in accordance with the general rule in § 1.1014–1:

(1) Without regard to the date of the decedent's death, property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, whether the property was acquired under the decedent's will or under the law governing the descent and distribution of the property of decedents. However, see paragraph (c)(1) of this section if the property was acquired by bequest or inheritance from a decedent dying after August 26, 1937, and if such property consists of stock or securities of a foreign personal holding company.

(2) Without regard to the date of the decedent's death, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust.

(3) In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust.

(4) Without regard to the date of the decedent's death, property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will. (See section 2041(b) for definition of general power of appointment.)

(5) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in that property was includible in determining the value of the decedent's gross estate under part III, chapter 11 of the Internal Revenue Code of 1954 (relating to the estate tax) or section 811 of the Internal Revenue Code of 1939. It is not necessary for the application of this subparagraph that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable.

(6) In the case of decedents dying after December 31, 1950, and before January 1, 1954, property which represents the survivor's interest in a joint and survivor's annuity if the value of any part of that interest was required to be included in determining the value of

the decedent's gross estate under section 811 of the Internal Revenue Code of 1939. It is necessary only that the value of a part of the survivor's interest in the annuity be includible in the gross estate under section 811. It is not necessary for the application of this subparagraph that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable.

(b) *Property acquired from a decedent dying after December 31, 1953*—(1) *In general.* In addition to the property described in paragraph (a) of this section, and except as otherwise provided in subparagraph (3) of this paragraph, in the case of a decedent dying after December 31, 1953, property shall also be considered to have been acquired from the decedent to the extent that both of the following conditions are met: (i) The property was acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), and (ii) the property is includible in the decedent's gross estate under the provisions of the Internal Revenue Code of 1954, or the Internal Revenue Code of 1939, because of such acquisition. The basis of such property in the hands of the person who acquired it from the decedent shall be determined in accordance with the general rule in §1.1014–1. See, however, §1.1014–6 for special adjustments if such property is acquired before the death of the decedent. See also subparagraph (3) of this paragraph for a description of property not within the scope of this paragraph.

(2) *Rules for the application of subparagraph (1) of this paragraph.* Except as provided in subparagraph (3) of this paragraph, this paragraph generally includes all property acquired from a decedent, which is includible in the gross estate of the decedent if the decedent died after December 31, 1953. It is not necessary for the application of this paragraph that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable. Property acquired prior to the death of a decedent which is includible in the decedent's gross estate, such as property transferred by a decedent in contemplation of death, and property held by a taxpayer and the decedent as joint tenants or as tenants by the entireties is within the scope of this paragraph. Also, this paragraph includes property acquired through the exercise or nonexercise of a power of appointment where such property is includible in the decedent's gross estate. It does not include property not includible in the decedent's gross estate such as property not situated in the United States acquired from a nonresident who is not a citizen of the United States.

(3) *Exceptions to application of this paragraph.* The rules in this paragraph are not applicable to the following property:

(i) Annuities described in section 72;

(ii) Stock or securities of a foreign personal holding company as described in section 1014(b)(5) (see paragraph (c)(1) of this section);

(iii) Property described in any paragraph other than paragraph (9) of section 1014(b). See paragraphs (a) and (c) of this section.

In illustration of subdivision (ii), assume that A acquired by gift stock of a character described in paragraph (c)(1) of this section from a donor and upon the death of the donor the stock was includible in the donor's estate as being a gift in contemplation of death. A's basis in the stock would not be determined by reference to its fair market value at the donor's death under the general rule in section 1014(a). Furthermore, the special basis rules prescribed in paragraph (c)(1) of this section are not applicable to such property acquired by gift in contemplation of death. It will be necessary to refer to the rules in section 1015(a) to determine the basis.

(c) *Special basis rules with respect to certain property acquired from a decedent*—(1) *Stock or securities of a foreign personal holding company.* The basis of certain stock or securities of a foreign corporation which was a foreign personal holding company with respect to its taxable year next preceding the date of the decedent's death is governed by a special rule. If such stock was acquired from a decedent dying after August 26, 1937, by bequest or inheritance, or by the decedent's estate

from the decedent, the basis of the property in the hands of the person who so acquired it (notwithstanding any other provision of section 1014) shall be the fair market value of such property at the date of the decedent's death or the adjusted basis of the stock in the hands of the decedent, whichever is lower.

(2) *Spouse's interest in community property of decedent dying after October 21, 1942, and on or before December 31, 1947.* In the case of a decedent dying after October 21, 1942, and on or before December 31, 1947, a special rule is provided for determining the basis of such part of any property, representing the surviving spouse's one-half share of property held by the decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, as was included in determining the value of the decedent's gross estate, if a tax under chapter 3 of the Internal Revenue Code of 1939 was payable upon the decedent's net estate. In such case the basis shall be the fair market value of such part of the property at the date of death (or the optional valuation elected under section 811(j) of the Internal Revenue Code of 1939) or the adjusted basis of the property determined without regard to this subparagraph, whichever is the higher.

§ 1.1014–3 Other basis rules.

(a) *Fair market value.* For purposes of this section and § 1.1014–1, the value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax or the alternate value as appraised for such purpose, whichever is applicable, shall be deemed to be its fair market value. If no estate tax return is required to be filed under section 6018 (or under section 821 or 864 of the Internal Revenue Code of 1939), the value of the property appraised as of the date of the decedent's death for the purpose of State inheritance or transmission taxes shall be deemed to be its fair market value and no alternate valuation date shall be applicable.

(b) *Property acquired from a decedent dying before March 1, 1913.* If the decedent died before March 1, 1913, the fair market value on that date is taken in lieu of the fair market value on the date of death, but only to the same extent and for the same purposes as the fair market value on March 1, 1913, is taken under section 1053.

(c) *Reinvestments by a fiduciary.* The basis of property acquired after the death of the decedent by a fiduciary as an investment is the cost or other basis of such property to the fiduciary, and not the fair market value of such property at the death of the decedent. For example, the executor of an estate purchases stock of X company at a price of $100 per share with the proceeds of the sale of property acquired from a decedent. At the date of the decedent's death the fair market value of such stock was $98 per share. The basis of such stock to the executor or to a legatee, assuming the stock is distributed, is $100 per share.

(d) *Reinvestments of property transferred during life.* Where property is transferred by a decedent during life and the property is sold, exchanged, or otherwise disposed of before the decedent's death by the person who acquired the property from the decedent, the general rule stated in paragraph (a) of § 1.1014–1 shall not apply to such property. However, in such a case, the basis of any property acquired by such donee in exchange for the original property, or of any property acquired by the donee through reinvesting the proceeds of the sale of the original property, shall be the fair market value of the property thus acquired at the date of the decedent's death (or applicable alternate valuation date) if the property thus acquired is properly included in the decedent's gross estate for Federal estate tax purposes. These rules also apply to property acquired by the donee in any further exchanges or in further reinvestments. For example, on January 1, 1956, the decedent made a gift of real property to a trust for the benefit of his children, reserving to himself the power to revoke the trust at will. Prior to the decedent's death, the trustee sold the real property and invested the proceeds in stock of the Y company at $50 per share. At the time of the decedent's death, the value of such stock was $75 per share. The corpus of the trust was required to

be included in the decedent's gross estate owing to his reservation of the power of revocation. The basis of the Y company stock following the decedent's death is $75 per share. Moreover, if the trustee sold the Y Company stock before the decedent's death for $65 a share and reinvested the proceeds in Z company stock which increased in value to $85 per share at the time of the decedent's death, the basis of the Z company stock following the decedent's death would be $85 per share.

(e) *Alternate valuation dates.* Section 1014(a) provides a special rule applicable in determining the basis of property described in § 1.1014–2 where—

(1) The property is includible in the gross estate of a decedent who died after October 21, 1942, and

(2) The executor elects for estate tax purposes under section 2032, or section 811(j) of the Internal Revenue Code of 1939, to value the decedent's gross estate at the alternate valuation date prescribed in such sections.

In those cases, the value applicable in determining the basis of the property is not the value at the date of the decedent's death but (with certain limitations) the value at the date one year after his death if not distributed, sold, exchanged, or otherwise disposed of in the meantime. If such property was distributed, sold, exchanged, or otherwise disposed of within one year after the date of the decedent's death by the person who acquired it from the decedent, the value applicable in determining the basis is its value as of the date of such distribution, sale, exchange, or other disposition. For illustrations of the operation of this paragraph, see the estate tax regulations under section 2032.

§ 1.1014–4 Uniformity of basis; adjustment to basis.

(a) *In general.* (1) The basis of property acquired from a decedent, as determined under section 1014(a) or section 1022, is uniform in the hands of every person having possession or enjoyment of the property at any time under the will or other instrument or under the laws of descent and distribution. The principle of uniform basis means that the basis of the property (to which proper adjustments must, of course, be made) will be the same, or uniform, whether the property is possessed or enjoyed by the executor or administrator, the heir, the legatee or devisee, or the trustee or beneficiary of a trust created by a will or an inter vivos trust. In determining the amount allowed or allowable to a taxpayer in computing taxable income as deductions for depreciation or depletion under section 1016(a)(2), the uniform basis of the property shall at all times be used and adjusted. The sale, exchange, or other disposition by a life tenant or remainderman of his interest in property will, for purposes of this section, have no effect upon the uniform basis of the property in the hands of those who acquired it from the decedent. Thus, gain or loss on sale of trust assets by the trustee will be determined without regard to the prior sale of any interest in the property. Moreover, any adjustment for depreciation shall be made to the uniform basis of the property without regard to such prior sale, exchange, or other disposition.

(2) Under the law governing wills and the distribution of the property of decedents, all titles to property acquired by bequest, devise, or inheritance relate back to the death of the decedent, even though the interest of the person taking the title was, at the date of death of the decedent, legal, equitable, vested, contingent, general, specific, residual, conditional, executory, or otherwise. Accordingly, there is a common acquisition date for all titles to property acquired from a decedent within the meaning of section 1014 or section 1022, and, for this reason, a common or uniform basis for all such interests. For example, if distribution of personal property left by a decedent is not made until one year after his death, the basis of such property in the hands of the legatee is its fair market value at the time when the decedent died, and not when the legatee actually received the property. If the bequest is of the residue to trustees in trust, and the executors do not distribute the residue to such trustees until five years after the death of the decedent, the basis of each piece of property left by the decedent and thus received, in the hands of the trustees, is its fair market

value at the time when the decedent dies. If the bequest is to trustees in trust to pay to A during his lifetime the income of the property bequeathed, and after his death to distribute such property to the survivors of a class, and upon A's death the property is distributed to the taxpayer as the sole survivor, the basis of such property, in the hands of the taxpayer, is its fair market value at the time when the decedent died. The purpose of the Code in prescribing a general uniform basis rule for property acquired from a decedent is, on the one hand, to tax the gain, in respect of such property, to him who realizes it (without regard to the circumstances that at the death of the decedent it may have been quite uncertain whether the taxpayer would take or gain anything); and, on the other hand, not to recognize as gain any element of value resulting solely from the circumstance that the possession or enjoyment of the taxpayer was postponed. Such postponement may be, for example, until the administration of the decedent's estate is completed, until the period of the possession or enjoyment of another has terminated, or until an uncertain event has happened. It is the increase or decrease in the value of property reflected in a sale or other disposition which is recognized as the measure of gain or loss.

(3) The principles stated in subparagraphs (1) and (2) of this paragraph do not apply to property transferred by an executor, administrator or trustee, to an heir, legatee, devisee or beneficiary under circumstances such that the transfer constitutes a sale or exchange. In such a case, gain or loss must be recognized by the transferor to the extent required by the revenue laws, and the transferee acquires a basis equal to the fair market value of the property on the date of the transfer. Thus, for example, if the trustee of a trust created by will transfers to a beneficiary, in satisfaction of a specific bequest of $10,000, securities which had a fair market value of $9,000 on the date of the decedent's death (the applicable valuation date) and $10,000 on the date of the transfer, the trust realizes a taxable gain of $1,000 and the basis of the securities in the hands of the beneficiary would be $10,000. As a further example, if the executor of an estate transfers to a trust property worth $200,000, which had a fair market value of $175,000 on the date of the decedent's death (the applicable valuation date), in satisfaction of the decedent's bequest in trust for the benefit of his wife of cash or securities to be selected by the executor in an amount sufficient to utilize the marital deduction to the maximum extent authorized by law (after taking into consideration any other property qualifying for the marital deduction), capital gain in the amount of $25,000 would be realized by the estate and the basis of the property in the hands of the trustees would be $200,000. If, on the other hand, the decedent bequeathed a fraction of his residuary estate to a trust for the benefit of his wife, which fraction will not change regardless of any fluctuations in value of property in the decedent's estate after his death, no gain or loss would be realized by the estate upon transfer of property to the trust, and the basis of the property in the hands of the trustee would be its fair market value on the date of the decedent's death or on the alternate valuation date.

(b) *Multiple interests.* Where more than one person has an interest in property acquired from a decedent, the basis of such property shall be determined and adjusted without regard to the multiple interests. The basis of computing gain or loss on the sale of any one of such multiple interests shall be determined under §1.1014–5. Thus, the deductions for depreciation and for depletion allowed or allowable, under sections 167 and 611, to a legal life tenant as if the life tenant were the absolute owner of the property, constitute an adjustment to the basis of the property not only in the hands of the life tenant, but also in the hands of the remainderman and every other person to whom the same uniform basis is applicable. Similarly, the deductions allowed or allowable under sections 167 and 611, both to the trustee and to the trust beneficiaries, constitute an adjustment to the basis of the property not only in the hands of the trustee, but also in the hands of the trust beneficiaries and every other person to whom the uniform basis is applicable. See, however, section 262. Similarly,

adjustments in respect of capital expenditures or losses, tax-free distributions, or other distributions applicable in reduction of basis, or other items for which the basis is adjustable are made without regard to which one of the persons to whom the same uniform basis is applicable makes the capital expenditures or sustains the capital losses, or to whom the tax-free or other distributions are made, or to whom the deductions are allowed or allowable. See §1.1014–6 for adjustments in respect of property acquired from a decedent prior to his death.

(c) *Records.* The executor or other legal representative of the decedent, the fiduciary of a trust under a will, the life tenant and every other person to whom a uniform basis under this section is applicable, shall maintain records showing in detail all deductions, distributions, or other items for which adjustment to basis is required to be made by sections 1016 and 1017, and shall furnish to the district director such information with respect to those adjustments as he may require.

(d) *Effective/applicability date.* This section applies on and after January 19, 2017. For rules before January 19, 2017, see §1.1014–4 as contained in 26 CFR part 1 revised as of April 1, 2016.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. , 45 FR 6089, 1980; T.D. 9811, 82 FR 6241, Jan. 19, 2017]

§ 1.1014–5 Gain or loss.

(a) *Sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent.* (1) Except as provided in paragraph (b) or (c) of this section with respect to the sale or other disposition after October 9, 1969, of a term interest in property, gain or loss from a sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent is determined by comparing the amount of the proceeds with the amount of that part of the adjusted uniform basis which is assignable to the interest so transferred. The adjusted uniform basis is the uniform basis of the entire property adjusted to the date of sale or other disposition of any such interest as required by sections 1016 and 1017. The uniform basis is the unadjusted basis of the entire property determined immediately after the decedent's death under the applicable sections of part II of subchapter O of chapter 1 of the Code.

(2) Except as provided in paragraph (b) of this section, the proper measure of gain or loss resulting from a sale or other disposition of an interest in property acquired from a decedent is so much of the increase or decrease in the value of the entire property as is reflected in such sale or other disposition. Hence, in ascertaining the basis of a life interest, remainder interest, or other interest which has been so transferred, the uniform basis rule contemplates that proper adjustments will be made to reflect the change in relative value of the interests on account of the passage of time.

(3) The factors set forth in the tables contained in §20.2031–7 or, for certain prior periods, §20.2031–7A, of part 20 of this chapter (Estate Tax Regulations) shall be used in the manner provided therein in determining the basis of the life interest, the remainder interest, or the term certain interest in the property on the date such interest is sold. The basis of the life interest, the remainder interest, or the term certain interest is computed by multiplying the uniform basis (adjusted to the time of the sale) by the appropriate factor. In the case of the sale of a life interest or a remainder interest, the factor used is the factor (adjusted where appropriate) which appears in the life interest or the remainder interest column of the table opposite the age (on the date of the sale) of the person at whose death the life interest will terminate. In the case of the sale of a term certain interest, the factor used is the factor (adjusted where appropriate) which appears in the term certain column of the table opposite the number of years remaining (on the date of sale) before the term certain interest will terminate.

(b) *Sale or other disposition of certain term interests*—(1) *In general.* In determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in §1.1001–1(f)(2)) the adjusted basis of which is determined pursuant,

or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010), that part of the adjusted uniform basis assignable under the rules of paragraph (a) of this section to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by section 1001(e) and § 1.1001–1(f).

(2) *Effective/applicability date.* The provisions of paragraph (b)(1) of this section relating to section 1022 are effective on and after January 19, 2017. For rules before January 19, 2017, see § 1.1014–5 as contained in 26 CFR part 1 revised as of April 1, 2016.

(c) *Sale or other disposition of a term interest in a tax-exempt trust*—(1) *In general.* In the case of any sale or other disposition by a taxable beneficiary of a term interest (as defined in § 1.1001–1(f)(2)) in a tax-exempt trust (as defined in paragraph (c)(2) of this section) to which section 1001(e)(3) applies, the taxable beneficiary's share of adjusted uniform basis, determined as of (and immediately before) the sale or disposition of that interest, is—

(i) That part of the adjusted uniform basis assignable to the term interest of the taxable beneficiary under the rules of paragraph (a) of this section reduced, but not below zero, by

(ii) An amount determined by applying the same actuarial share applied in paragraph (c)(1)(i) of this section to the sum of—

(A) The trust's undistributed net ordinary income within the meaning of section 664(b)(1) and § 1.664–1(d)(1)(ii)(*a*)(*1*) for the current and prior taxable years of the trust, if any; and

(B) The trust's undistributed net capital gains within the meaning of section 664(b)(2) and § 1.664–1(d)(1)(ii)(*a*)(*2*) for the current and prior taxable years of the trust, if any.

(2) *Tax-exempt trust defined.* For purposes of this section, the term *tax-exempt trust* means a charitable remainder annuity trust or a charitable remainder unitrust as defined in section 664.

(3) *Taxable beneficiary defined.* For purposes of this section, the term *taxable beneficiary* means any person other than an organization described in section 170(c) or exempt from taxation under section 501(a).

(4) *Effective/applicability date.* This paragraph (c) and paragraph (d) *Example 7* and *Example 8* of this section apply to sales and other dispositions of interests in tax-exempt trusts occurring on or after January 16, 2014, except for sales or dispositions occurring pursuant to a binding commitment entered into before January 16, 2014.

(d) *Illustrations.* The application of this section may be illustrated by the following examples, in which references are made to the actuarial tables contained in part 20 of this chapter (Estate Tax Regulations):

Example 1. Securities worth $500,000 at the date of decedent's death on January 1, 1971, are bequeathed to his wife, W, for life, with remainder over to his son, S. W is 48 years of age when the life interest is acquired. The estate does not elect the alternate valuation allowed by section 2032. By reference to § 20.2031–7A(c), the life estate factor for age 48, female, is found to be 0.77488 and the remainder factor for such age is found to be 0.22512. Therefore, the present value of the portion of the uniform basis assigned to W's life interest is $387,440 ($500,000 × 0.77488), and the present value of the portion of the uniform basis assigned to S's remainder interest is $112,560 ($500,000 × 0.22512). W sells her life interest to her nephew, A, on February 1, 1971, for $370,000, at which time W is still 48 years of age. Pursuant to section 1001(e), W realizes no loss; her gain is $370,000, the amount realized from the sale. A has a basis of $370,000 which he can recover by amortization deductions over W's life expectancy.

Example 2. The facts are the same as in example (1) except that W retains the life interest for 12 years, until she is 60 years of age, and then sells it to A on February 1, 1983, when the fair market value of the securities has increased to $650,000. By reference to § 20.2031–7A(c), the life estate factor for age 60, female, is found to be 0.63226 and the remainder factor for such age is found to be 0.36774. Therefore, the present value on February 1, 1983, of the portion of the uniform basis assigned to W's life interest is $316,130 ($500,000 × 0.63226) and the present value on that date of the portion of the uniform basis assigned to S's remainder interest is $183,870 ($500,000 × 0.36774). W sells her life interest for $410,969, that being the commuted value

of her remaining life interest in the securities as appreciated ($650,000 × 0.63226). Pursuant to section 1001(e), W's gain is $410,969, the amount realized. A has a basis of $410,969 which he can recover by amortization deductions over W's life expectancy.

Example 3. Unimproved land having a fair market value of $18,800 at the date of the decedent's death on January 1, 1970, is devised to A, a male, for life, with remainder over to B, a female. The estate does not elect the alternate valuation allowed by section 2032. On January 1, 1971, A sells his life interest to S for $12,500. S is not related to A or B. At the time of the sale, A is 39 years of age. By reference to § 20.2031–7A(c), the life estate factor for age 39, male, is found to be 0.79854. Therefore, the present value of the portion of the uniform basis assigned to A's life interest is $15,012.55 ($18,800 × 0.79854). This portion is disregarded under section 1001(e). A realizes no loss; his gain is $12,500, the amount realized. S has a basis of $12,500 which he can recover by amortization deductions over A's life expectancy.

Example 4. The facts are the same as in example (3) except that on January 1, 1971, A and B jointly sell the entire property to S for $25,000 and divide the proceeds equally between them. A and B are not related, and there is no element of gift or compensation in the transaction. By reference to § 20.2031–7A(c), the remainder factor for age 39, male, is found to be 0.20146. Therefore, the present value of the uniform basis assigned to B's remainder interest is $3,787.45 ($18,800 × 0.20146). On the sale A realizes a loss of $2,512.55 ($15,012.55 less $12,500), the portion of the uniform basis assigned to his life interest not being disregarded by reason of section 1001(e)(3). B's gain on the sale is $8,712.55 ($12,500 less $3,787.45). S has a basis in the entire property of $25,000, no part of which, however, can be recovered by amortization deductions over A's life expectancy.

Example 5. (a) Nondepreciable property having a fair market value of $54,000 at the date of decedent's death on January 1, 1971, is devised to her husband, H, for life and, after his death, to her daughter, D, for life, with remainder over to her grandson, G. The estate does not elect the alternate valuation allowed by section 2032. On January 1, 1973, H sells his life interest to D for $32,000. At the date of the sale, H is 62 years of age, and D is 45 years of age. By reference to § 20.2031–7A(c), the life estate factor for age 62, male, is found to be 0.52321. Therefore, the present value on January 1, 1973, of the portion of the adjusted uniform basis assigned to H's life interest is $28,253 ($54,000 × 0.52321). Pursuant to section 1001(e), H realizes no loss; his gain is $32,000, the amount realized from the sale. D has a basis of $32,000 which she can recover by amortization deductions over H's life expectancy.

(b) On January 1, 1976, D sells both life estates to G for $40,000. During each of the years 1973 through 1975, D is allowed a deduction for the amortization of H's life interest. At the date of the sale H is 65 years of age, and D is 48 years of age. For purposes of determining gain or loss on the sale by D, the portion of the adjusted uniform basis assigned to H's life interest and the portion assigned to D's life interest are not taken into account under section 1001(e). However, pursuant to § 1.1001–1(f)(1), D's cost basis in H's life interest, minus deductions for the amortization of such interest, is taken into account. On the sale, D realizes gain of $40,000 minus an amount which is equal to the $32,000 cost basis (for H's life estate) reduced by amortization deductions. G is entitled to amortize over H's life expectancy that part of the $40,000 cost which is attributable to H's life interest. That part of the $40,000 cost which is attributable to D's life interest is not amortizable by G until H dies.

Example 6. Securities worth $1,000,000 at the date of decedent's death on January 1, 1971, are bequeathed to his wife, W, for life, with remainder over to his son, S. W is 48 years of age when the life interest is acquired. The estate does not elect the alternate valuation allowed by section 2032. By reference to § 20.2031–7A(c), the life estate factor for age 48, female, is found to be 0.77488, and the remainder factor for such age is found to be 0.22512. Therefore, the present value of the portion of the uniform basis assigned to W's life interest is $774,880 ($1,000,000 × 0.77488), and the present value of the portion of the uniform basis assigned to S's remainder interest is $225,120 ($1,000,000 × 0.22512). On February 1, 1971, W transfers her life interest to corporation X in exchange for all of the stock of X pursuant to a transaction in which no gain or loss is recognized by reason of section 351. On February 1, 1972, W sells all of her stock in X to S for $800,000. Pursuant to section 1001(e) and § 1.1001–1(f)(2), W realizes no loss; her gain is $800,000, the amount realized from the sale. On February 1, 1972, X sells to N for $900,000 the life interest transferred to it by W. Pursuant to section 1001(e) and § 1.1001–1(f)(1), X realizes no loss; its gain is $900,000, the amount realized from the sale. N has a basis of $900,000 which he can recover by amortization deductions over W's life expectancy.

Example 7. (a) Grantor creates a charitable remainder unitrust (CRUT) on Date 1 in which Grantor retains a unitrust interest and irrevocably transfers the remainder interest to Charity. Grantor is an individual taxpayer subject to income tax. CRUT meets the requirements of section 664 and is exempt from income tax.

(b) Grantor's basis in the shares of X stock used to fund CRUT is $10x. On Date 2, CRUT sells the X stock for $100x. The $90x of gain is exempt from income tax under section

664(c)(1). On Date 3, CRUT uses the $100x proceeds from its sale of the X stock to purchase Y stock. On Date 4, CRUT sells the Y stock for $110x. The $10x of gain on the sale of the Y stock is exempt from income tax under section 664(c)(1). On Date 5, CRUT uses the $110x proceeds from its sale of Y stock to buy Z stock. On Date 5, CRUT's basis in its assets is $110x and CRUT's total undistributed net capital gains are $100x.

(c) Later, when the fair market value of CRUT's assets is $150x and CRUT has no undistributed net ordinary income, Grantor and Charity sell all of their interests in CRUT to a third person. Grantor receives $100x for the retained unitrust interest, and Charity receives $50x for its interest. Because the entire interest in CRUT is transferred to the third person, section 1001(e)(3) prevents section 1001(e)(1) from applying to the transaction. Therefore, Grantor's gain on the sale of the retained unitrust interest in CRUT is determined under section 1001(a), which provides that Grantor's gain on the sale of that interest is the excess of the amount realized, $100x, over Grantor's adjusted basis in the interest.

(d) Grantor's adjusted basis in the unitrust interest in CRUT is that portion of CRUT's adjusted uniform basis that is assignable to Grantor's interest under § 1.1014–5, which is Grantor's actuarial share of the adjusted uniform basis. In this case, CRUT's adjusted uniform basis in its sole asset, the Z stock, is $110x. However, paragraph (c) of this section applies to the transaction. Therefore, Grantor's actuarial share of CRUT's adjusted uniform basis (determined by applying the factors set forth in the tables contained in § 20.2031–7 of this chapter) is reduced by an amount determined by applying the same factors to the sum of CRUT's $0 of undistributed net ordinary income and its $100x of undistributed net capital gains.

(e) In determining Charity's share of the adjusted uniform basis, Charity applies the factors set forth in the tables contained in § 20.2031–7 of this chapter to the full $110x of basis.

Example 8. (a) Grantor creates a charitable remainder annuity trust (CRAT) on Date 1 in which Grantor retains an annuity interest and irrevocably transfers the remainder interest to Charity. Grantor is an individual taxpayer subject to income tax. CRAT meets the requirements of section 664 and is exempt from income tax.

(b) Grantor funds CRAT with shares of X stock having a basis of $50x. On Date 2, CRAT sells the X stock for $150x. The $100x of gain is exempt from income tax under section 664(c)(1). On Date 3, CRAT distributes $10x to Grantor, and uses the remaining $140x of net proceeds from its sale of the X stock to purchase Y stock. Grantor treats the $10x distribution as capital gain, so that CRAT's remaining undistributed net capital gains amount described in section 664(b)(2) and § 1.664–1(d) is $90x.

(c) On Date 4, when the fair market value of CRAT's assets, which consist entirely of the Y stock, is still $140x, Grantor and Charity sell all of their interests in CRAT to a third person. Grantor receives $126x for the retained annuity interest, and Charity receives $14x for its remainder interest. Because the entire interest in CRAT is transferred to the third person, section 1001(e)(3) prevents section 1001(e)(1) from applying to the transaction. Therefore, Grantor's gain on the sale of the retained annuity interest in CRAT is determined under section 1001(a), which provides that Grantor's gain on the sale of that interest is the excess of the amount realized, $126x, over Grantor's adjusted basis in that interest.

(d) Grantor's adjusted basis in the annuity interest in CRAT is that portion of CRAT's adjusted uniform basis that is assignable to Grantor's interest under § 1.1014–5, which is Grantor's actuarial share of the adjusted uniform basis. In this case, CRAT's adjusted uniform basis in its sole asset, the Y stock, is $140x. However, paragraph (c) of this section applies to the transaction. Therefore, Grantor's actuarial share of CRAT's adjusted uniform basis (determined by applying the factors set forth in the tables contained in § 20.2031–7 of this chapter) is reduced by an amount determined by applying the same factors to the sum of CRAT's $0 of undistributed net ordinary income and its $90x of undistributed net capital gains.

(e) In determining Charity's share of the adjusted uniform basis, Charity applies the factors set forth in the tables contained in § 20.2031–7 of this chapter to determine its actuarial share of the full $140x of basis.

[T.D. 7142, 36 FR 18951, Sept. 24, 1971, as amended by T.D. 8540, 59 FR 30102, June 10, 1994; T.D. 9729, 80 FR 48250, Aug. 12, 2015; T.D. 9811, 82 FR 6241, Jan. 19, 2017]

§ 1.1014–6 Special rule for adjustments to basis where property is acquired from a decedent prior to his death.

(a) *In general.* (1) The basis of property described in section 1014(b)(9) which is acquired from a decedent prior to his death shall be adjusted for depreciation, obsolescence, amortization, and depletion allowed the taxpayer on such property for the period prior to the decedent's death. Thus, in general, the adjusted basis of such property will be its fair market value at the decedent's death, or the applicable alternate valuation date, less the amount allowed (determined with regard to section 1016(a)(2)(B)) to the taxpayer as deductions for exhaustion, wear and

tear, obsolescence, amortization, and depletion for the period held by the taxpayer prior to the decedent's death. The deduction allowed for a taxable year in which the decedent dies shall be an amount properly allocable to that part of the year prior to his death. For a discussion of the basis adjustment required by section 1014(b)(9) where property is held in trust, see paragraph (c) of this section.

(2) Where property coming within the purview of subparagraph (1) of this paragraph was held by the decedent and his surviving spouse as tenants by the entirety or as joint tenants with right of survivorship, and joint income tax returns were filed by the decedent and the surviving spouse in which the deductions referred to in subparagraph (1) were taken, there shall be allocated to the surviving spouse's interest in the property that proportion of the deductions allowed for each period for which the joint returns were filed which her income from the property bears to the total income from the property. Each spouse's income from the property shall be determined in accordance with local law.

(3) The application of this paragraph may be illustrated by the following examples:

Example 1. The taxpayer acquired income-producing property by gift on January 1, 1954. The property had a fair market value of $50,000 on the date of the donor's death, January 1, 1956, and was included in his gross estate at that amount for estate tax purposes as a transfer in contemplation of death. Depreciation in the amount of $750 per year was allowable for each of the taxable years 1954 and 1955. However, the taxpayer claimed depreciation in the amount of $500 for each of these years (resulting in a reduction in his taxes) and his income tax returns were accepted as filed. The adjusted basis of the property as of the date of the decedent's death is $49,000 ($50,000, the fair market value at the decedent's death, less $1,000, the total of the amounts actually allowed as deductions).

Example 2. On July 1, 1952, H purchased for $30,000 income-producing property which he conveyed to himself and W, his wife, as tenants by the entirety. Under local law each spouse was entitled to one-half of the income therefrom. H died on January 1, 1955, at which time the fair market value of the property was $40,000. The entire value of the property was included in H's gross estate. H and W filed joint income tax returns for the years 1952, 1953, and 1954. The total depreciation allowance for the year 1952 was $500 and for each of the other years 1953 and 1954 was $1,000. One-half of the $2,500 depreciation will be allocated to W. The adjusted basis of the property in W's hands of January 1, 1955, was $38,750 ($40,000, value on the date of H's death, less $1,250, depreciation allocated to W for periods before H's death). However, if, under local law, all of the income from the property was allocable to H, no adjustment under this paragraph would be required and W's basis for the property as of the date of H's death would be $40,000.

(b) *Multiple interests in property described in section 1014(b)(9) and acquired from a decedent prior to his death.* (1) Where more than one person has an interest in property described in section 1014(b)(9) which was acquired from a decedent before his death, the basis of such property and of each of the several interests therein shall, in general, be determined and adjusted in accordance with the principles contained in §§ 1.1014–4 and 1.1014–5, relating to the uniformity of basis rule. Application of these principles to the determination of basis under section 1014(b)(9) is shown in the remaining subparagraphs of this paragraph in connection with certain commonly encountered situations involving multiple interests in property acquired from a decedent before his death.

(2) Where property is acquired from a decedent before his death, and the entire property is subsequently included in the decedent's gross estate for estate tax purposes, the uniform basis of the property, as well as the basis of each of the several interests in the property, shall be determined by taking into account the basis adjustments required by section 1014(a) owing to such inclusion of the entire property in the decedent's gross estate. For example, suppose that the decedent transfers property in trust, with a life estate to A, and the remainder to B or his estate. The transferred property consists of 100 shares of the common stock of X Corporation, with a basis of $10,000 at the time of the transfer. At the time of the decedent's death the value of the stock is $20,000. The transfer is held to have been made in contemplation of death and the entire value of the trust is included in the decedent's gross estate. Under section 1014(a), the uniform basis

of the property in the hands of the trustee, the life tenant, and the remainderman, is $20,000. If immediately prior to the decedent's death, A's share of the uniform basis of $10,000 was $6,000, and B's share was $4,000, then, immediately after the decedent's death, A's share of the uniform basis of $20,000 is $12,000, and B's share is $8,000.

(3)(i) In cases where, due to the operation of the estate tax, only a portion of property acquired from a decedent before his death is included in the decedent's gross estate, as in cases where the decedent retained a reversion to take effect upon the expiration of a life estate in another, the uniform basis of the entire property shall be determined by taking into account any basis adjustments required by section 1014(a) owing to such inclusion of a portion of the property in the decedent's gross estate. In such cases the uniform basis is the adjusted basis of the entire property immediately prior to the decedent's death increased (or decreased) by an amount which bears the same relation to the total appreciation (or diminution) in value of the entire property (over the adjusted basis of the entire property immediately prior to the decedent's death) as the value of the property included in the decedent's gross estate bears to the value of the entire property. For example, assume that the decedent creates a trust to pay the income to A for life, remainder to B or his estate. The trust instrument further provides that if the decedent should survive A, the income shall be paid to the decedent for life. Assume that the decedent predeceases A, so that, due to the operation of the estate tax, only the present value of the remainder interest is included in the decedent's gross estate. The trust consists of 100 shares of the common stock of X Corporation with an adjusted basis immediately prior to the decedent's death of $10,000 (as determined under section 1015). At the time of the decedent's death, the value of the stock is $20,000, and the value of the remainder interest in the hands of B is $8,000. The uniform basis of the entire property following the decedent's death is $14,000, computed as follows:

Uniform basis prior to decedent's death	$10,000
plus	
Increase in uniform basis (determined by the following formula)	4,000
[Increase in uniform basis (to be determined)/$10,000 (total appreciation)]=	
[$8,000 (value of property included in gross estate)/$20,000 (value of entire property)]	
Uniform basis under section 1014(a)	14,000

(ii) In cases of the type described in subdivision (i) of this subparagraph, the basis of any interest which is included in the decedent's gross estate may be ascertained by adding to (or subtracting from) the basis of such interest determined immediately prior to the decedent's death the increase (or decrease) in the uniform basis of the property attributable to the inclusion of the interest in the decedent's gross estate. Where the interest is sold or otherwise disposed of at any time after the decedent's death, proper adjustment must be made in order to reflect the change in value of the interest on account of the passage of time, as provided in § 1.1014–5. For an illustration of the operation of this subdivision, see step 6 of the example in § 1.1014–7.

(iii) In cases of the type described in subdivision (i) of this subparagraph (cases where, due to the operation of the estate tax, only a portion of the property is included in the decedent's gross estate), the basis for computing the depreciation, amortization, or depletion allowance shall be the uniform basis of the property determined under section 1014(a). However, the manner of taking into account such allowance computed with respect to such uniform basis is subject to the following limitations:

(*a*) In cases where the value of the life interest is not included in the decedent's gross estate, the amount of such allowance to the life tenant under section 167(h) (or section 611(b)) shall not exceed (or be less than) the amount which would have been allowable to the life tenant if no portion of the basis of the property was determined under section 1014(a). Proper adjustment shall be made for the amount allowable to the life tenant, as required by section 1016. Thus, an appropriate adjustment shall be made to the uniform basis of the property in the hands of the trustee, to the basis of the life interest in the hands of the life tenant, and to the

basis of the remainder in the hands of the remainderman.

(*b*) Any remaining allowance (that is, the increase in the amount of depreciation, amortization, or depletion allowable resulting from any increase in the uniform basis of the property under section 1014(a)) shall not be allowed to the life tenant. The remaining allowance shall, instead, be allowed to the trustee to the extent that the trustee both (*1*) is required or permitted, by the governing trust instrument (or under local law), to maintain a reserve for depreciation, amortization, or depletion, and (*2*) actually maintains such a reserve. If, in accordance with the preceding sentence, the trustee does maintain such a reserve, the remaining allowance shall be taken into account, under section 1016, in adjusting the uniform basis of the property in the hands of the trustee and in adjusting the basis of the remainder interest in the hands of the remainderman, but shall not be taken into account, under section 1016, in determining the basis of the life interest in the hands of the life tenant. For an example of the operation of this subdivision, see paragraph (b) of § 1.1014–7.

(4) In cases where the basis of any interest in property is not determined under section 1014(a), as where such interest (i) is not included in the decedent's gross estate, or (ii) is sold, exchanged or otherwise disposed of before the decedent's death, the basis of such interest shall be determined under other applicable provisions of the Code. To illustrate, in the example shown in subparagraph (3)(i) of this paragraph the basis of the life estate in the hands of A shall be determined under section 1015, relating to the basis of property acquired by gift. If, on the other hand, A had sold his life interest prior to the decedent's death, the basis of the life estate in the hands of A's transferee would be determined under section 1012.

(c) *Adjustments for deductions allowed prior to the decedent's death.* (1) As stated in paragraph (a) of this section, section 1014(b)(9) requires a reduction in the uniform basis of property acquired from a decedent before his death for certain deductions allowed in respect of such property during the decedent's lifetime. In general, the amount of the reduction in basis required by section 1014(b)(9) shall be the aggregate of the deductions allowed in respect of the property, but shall not include deductions allowed in respect of the property to the decedent himself. In cases where, owing to the operation of the estate tax, only a part of the value of the entire property is included in the decedent's gross estate, the amount of the reduction required by section 1014(b)(9) shall be an amount which bears the same relation to the total of all deductions (described in paragraph (a) of this section) allowed in respect of the property as the value of the property included in the decedent's gross estate bears to the value of the entire property.

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

Example 1. The decedent creates a trust to pay the income to A for life, remainder to B or his estate. The property transferred in trust consists of an apartment building with a basis of $50,000 at the time of the transfer. The decedent dies 2 years after the transfer is made and the gift is held to have been made in contemplation of death. Depreciation on the property was allowed in the amount of $1,000 annually. At the time of the decedent's death the value of the property is $58,000. The uniform basis of the property in the hands of the trustee, the life tenant, and the remainderman, immediately after the decedent's death is $56,000 ($58,000, fair market value of the property immediately after the decedent's death, reduced by $2,000, deductions for depreciation allowed prior to the decedent's death).

Example 2. The decedent creates a trust to pay the income to A for life, remainder to B or his estate. The trust instrument provides that if the decedent should survive A, the income shall be paid to the decedent for life. The decedent predeceases A and the present value of the remainder interest is included in the decedent's gross estate for estate tax purposes. The property transferred consists of an apartment building with a basis of $110,000 at the time of the transfer. Following the creation of the trust and during the balance of the decedent's life, deductions for depreciation were allowed on the property in the amount of $10,000. At the time of decedent's death the value of the entire property is $150,000, and the value of the remainder interest is $100,000. Accordingly, the uniform basis of the property in the hands of

the trustee, the life tenant, and the remainderman, as adjusted under section 1014(b)(9), is $126,666, computed as follows:

Uniform basis prior to decedent's death	$100,000
plus	
Increase in uniform basis—before reduction (determined by the following formula)	33,333
[Increase in uniform basis (to be determined)/$50,000 (total appreciation of property since time of transfer)]=	
[$100,000 (value of property included in gross estate)/$150,000 (value of entire property)]	
	133,333
less	
Deductions allowed prior to decedent's death—taken into account under section 1014(b)(9) (determined by the following formula)	6,667
[Prior deductions taken into account (to be determined) $10,000 (total deductions allowed prior to decedent's death)]=	
[$100,000 (value of property included in gross estate) $150,000 (value of entire property)]	
Uniform basis under section 1014	126,666

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3656, Mar. 24, 1964; T.D. 7142, 36 FR 18952, Sept. 24, 1971]

§ 1.1014–7 Example applying rules of §§ 1.1014–4 through 1.1014–6 to case involving multiple interests.

(a) On January 1, 1950, the decedent creates a trust to pay the income to A for life, remainder to B or his estate. The trust instrument provides that if the decedent should survive A, the income shall be paid to the decedent for life. The decedent, who died on January 1, 1955, predeceases A, so that, due to the operation of the estate tax, only the present value of the remainder interest is included in the decedent's gross estate. The trust consists of an apartment building with a basis of $30,000 at the time of transfer. Under the trust instrument the trustee is required to maintain a reserve for depreciation. During the decedent's lifetime depreciation is allowed in the amount of $800 annually. At the time of the decedent's death the value of the apartment building is $45,000. A, the life tenant, is 43 years of age at the time of the decedent's death. Immediately after the decedent's death, the uniform basis of the entire property under section 1014(a) is $32,027; A's basis for the life interest is $15,553; and B's basis for the remainder interest is $16,474, computed as follows:

Step 1. Uniform basis (adjusted) immediately prior to decedent's death:		
Basis at time of transfer		$30,000
less		
Depreciation allowed under section 1016 before decedent's death ($800 × 5)		4,000
		26,000
Step 2. Value of property included in decedent's gross estate:		
0.40180 (remainder factor, age 43) × $45,000 (value of entire property)		$18,081
Step 3. Uniform basis of property under section 1014(a), before reduction required by section 1014(b)(9):		
Uniform basis (adjusted) prior to decedent's death		26,000
Increase in uniform basis (determined by the following formula)		7,634
Increase in uniform basis (to be determined) $19,000 (total appreciation, $45,000 − $26,000)]=		
$18,081 (value of property included in gross estate) $45,000 (value of entire property)]		
		33,634
Step 4. Uniform basis reduced as required by section 1014(b)(9) for deductions allowed prior to death:		
Uniform basis before reduction		$33,634
less		
Deductions allowed prior to decedent's death—taken into account under section 1014(b)(9) (determined by the following formula)		1,607
Prior deductions taken into account (to be determined) $4,000 (total deductions allowed prior to decedent's death)]=		
$18,081 (value of property included in gross estate) $45,000 (value of entire property)		
		32,027
Step 5. A's basis for the life interest at the time of the decedent's death, determined under section 1015: 0.59820 (life factor, age 43) × $26,000		15,553
Step 6. B's basis for the remainder interest, determined under section 1014(a): Basis prior to the decedent's death:		
0.40180 (remainder factor, age 43) × $26,000		10,447
plus		
Increase in uniform basis owing to decedent's death:		
Increase in uniform basis	$7,634	
plus		
Reduction required by section 1014(b)(9)	1,607	
		6,027
		16,474

(b) Assume the same facts as in paragraph (a) of this section. Assume further, that following the decedent's death depreciation is allowed in the amount of $1,000 annually. As of January 1, 1964, when A's age is 52, the adjusted uniform basis of the entire property is $23,027; A's basis for the life interest is $9,323; and B's basis for the remainder interest is $13,704, computed as follows:

Step 7. Uniform basis (adjusted) as of January 1, 1964:	
Uniform basis determined under section 1014(a), reduced as required by section 1014(b)(9)	$32,027

less	
Depreciation allowed since decedent's death ($1,000 × 9)	9,000
	23,027
Step 8. Allocable share of adjustment for depreciation allowable in the nine years since the decedent's death:	
A's interest	
0.49587 (life factor, age 52) × $7,200 ($800, depreciation attributable to uniform basis before increase under section 1014(a), × 9)	3,570
B's interest	
0.50413 (remainder factor, age 52) × $7,200 ($800, depreciation attributable to uniform basis before increase under section 1014(a), × 9)	3,630
plus	
$200 (annual depreciation attributable to increase in uniform basis under section 1014(a)) × 9	1,800
	5,430
Step 9. Tentative bases of A's and B's interests as of January 1, 1964 (before adjustment for depreciation).	
A's interest	
0.49587 (life factor, age 52) × $26,000 (adjusted uniform basis immediately before decedent's death)	12,893
B's interest	
0.50413 (remainder factor, age 52) × $26,000 (adjusted uniform basis immediately before decedent's death)	13,107
plus	
Increase in uniform basis owing to inclusion of remainder in decedent's gross estate	6,027
	19,134
Step 10. Bases of A's and B's interests as of January 1, 1964.	
A	
Tentative basis (Step 9)	12,893
less	
Allocable depreciation (Step 8)	3,570
	9,323
B	
Tentative basis (Step 9)	19,134
less	
Allocable depreciation (Step 8)	5,430
	13,704

§ 1.1014–8 Bequest, devise, or inheritance of a remainder interest.

(a)(1) Where property is transferred for life, with remainder in fee, and the remainderman dies before the life tenant, no adjustment is made to the uniform basis of the property on the death of the remainderman (see paragraph (a) of § 1.1014–4). However, the basis of the remainderman's heir, legatee, or devisee for the remainder interest is determined by adding to (or subtracting from) the part of the adjusted uniform basis assigned to the remainder interest (determined in accordance with the principles set forth in §§ 1.1014–4 through 1.1014–6) the difference between—

(i) The value of the remainder interest included in the remainderman's estate, and

(ii) The basis of the remainder interest immediately prior to the remainderman's death.

(2) The basis of any property distributed to the heir, legatee, or devisee upon termination of a trust (or legal life estate) or at any other time (unless included in the gross income of the legatee or devisee) shall be determined by adding to (or subtracting from) the adjusted uniform basis of the property thus distributed the difference between—

(i) The value of the remainder interest in the property included in the remainderman's estate, and

(ii) The basis of the remainder interest in the property immediately prior to the remainderman's death.

(b) The provisions of paragraph (a) of this section are illustrated by the following examples:

Example 1. Assume that, under the will of a decedent, property consisting of common stock with a value of $1,000 at the time of the decedent's death is transferred in trust, to pay the income to A for life, remainder to B or to B's estate. B predeceases A and bequeaths the remainder interest to C. Assume that B dies on January 1, 1956, and that the value of the stock originally transferred is $1,600 at B's death. A's age at that time is 37. The value of the remainder interest included in B's estate is $547 (0.34185, remainder factor age 37, × $1,600), and hence $547 is C's basis for the remainder interest immediately after B's death. Assume that C sells the remainder interest on January 1, 1961, when A's age is 42. C's basis for the remainder interest at the time of such sale is $596, computed as follows:

Basis of remainder interest computed with respect to uniform basis of entire property (0.39131, remainder factor age 42, × $1,000, uniform basis of entire property)		$391
plus		
Value of remainder interest included in B's estate	$547	
less		
Basis of remainder interest immediately prior to B's death (0.34185, remainder factor age 37, × $1,000)	342	
		205
Basis of C's remainder interest at the time of sale		596

Example 2. Assume the same facts as in example (1), except that C does not sell the remainder interest. Upon A's death terminating the trust, C's basis for the stock distributed to him is computed as follows:

Uniform basis of the property, adjusted to date of termination of the trust		$1,000
plus		
Value of remainder interests in the property at the time of B's death	$547	
less		
B's share of uniform basis of the property at the time of his death	342	
		205
C's basis for the stock distributed to him upon the termination of the trust		1,205

Example 3. Assume the same facts as in example (2), except that the property transferred is depreciable. Assume further that $100 of depreciation was allowed prior to B's death and that $50 of depreciation is allowed between the time of B's death and the termination of the trust. Upon A's death terminating the trust, C's basis for the property distributed to him is computed as follows:

Uniform basis of the property, adjusted to date of termination of the trust:		
Uniform basis immediately after decedent's death	$1,000	
Depreciation allowed following decedent's death	150	
		$350
plus		
Value of remainder interest in the property at the time of B's death	547	
less		
B's share of uniform basis of the property at the time of his death (0.34185 × $900, uniform basis at B's death)	308	
		239
C's basis for the property distributed to him upon the termination of the trust		1,089

(c) The rules stated in paragraph (a) of this section do not apply where the basis of the remainder interest in the hands of the remainderman's transferee is determined by reference to its cost to such transferee. See also paragraph (a) of § 1.1014–4. Thus, if, in example (*1*) of paragraph (b) of this section B sold his remainder interest to C for $547 in cash, C's basis for the stock distributed to him upon the death of A terminating the trust is $547.

§ 1.1014–9 Special rule with respect to DISC stock.

(a) *In general.* If property consisting of stock of a DISC or former DISC (as defined in section 992(a) (1) or (3) as the case may be) is considered to have been acquired from a decedent (within the meaning of paragraph (a) or (b) of § 1.1014–2), the uniform basis of such stock under section 1014, as determined pursuant to §§ 1.1014–1 through 1.1014–8 shall be reduced as provided in this section. Such uniform basis shall be reduced by the amount (hereinafter referred to in this section as the amount of reduction), if any, which the decedent would have included in his gross income under section 995(c) as a dividend if the decedent had lived and sold such stock at its fair market value on the estate tax valuation date. If the alternate valuation date for Federal estate tax purposes is elected under section 2032, in computing the gain which the decedent would have had if he had lived and sold the stock on the alternate valuation date, the decedent's basis shall be determined with reduction for any distributions with respect to the stock which may have been made, after the date of the decedent's death and on or before the alternate valuation date, from the DISC's previously taxed income (as defined in section 996(f)(2)). For this purpose, the last sentence of section 996(e)(2) (relating to reductions of basis of DISC stock) shall not apply. For purposes of this section, if the corporation is not a DISC or former DISC at the date of the decedent's death but is a DISC for a taxable year which begins after such date and on or before the alternate valuation date, the corporation will be considered to be a DISC or former DISC only if the alternate valuation date is elected. The provisions of this paragraph apply with respect to stock of a DISC or former DISC which is included in the gross estate of the decedent, including but not limited to property which—

(1) Is acquired from the decedent before his death, and the entire property is subsequently included in the decedent's gross estate for estate tax purposes, or

(2) Is acquired property described in paragraph (d) of § 1.1014–3.

(b) *Portion of property acquired from decedent before his death included in decedent's gross estate*—(1) *In general.* In cases where, due to the operation of the estate tax, only a portion of property which consists of stock of a DISC or former DISC and which is acquired from a decedent before his death is included in the decedent's gross estate,

the uniform basis of such stock under section 1014, as determined pursuant to §§ 1.1014–1 through 1.1014–8, shall be reduced by an amount which bears the same ratio to the amount of reduction which would have been determined under paragraph (a) of this section if the entire property consisting of such stock were included in the decedent's gross estate as the value of such property included in the decedent's gross estate bears to the value of the entire property.

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

Example: The decedent creates a trust during his lifetime to pay the income to A for life, remainder to B or his estate. The trust instrument further provides that if the decedent shall survive A, the income shall be paid to the decedent for life. The decedent predeceases A, so that, due to the operation of the estate tax, only the present value of the remainder interest is included in the decedent's gross estate. The trust consists of 100 shares of the stock of X corporation (which is a DISC at the time the shares are transferred to the trust and at the time of the decedent's death) with an adjusted basis immediately prior to the decedent's death of $10,000 (as determined under section 1015). At the time of the decedent's death the value of the stock is $20,000, and the value of the remainder interest in the hands of B is $8,000. Applying the principles of paragraph (b)(3)(i) of § 1.1014–6, the uniform basis of the entire property following the decedent's death, prior to reduction pursuant to this paragraph, is $14,000. The amount of reduction which would have been determined under paragraph (a) of this section if the entire property consisting of such stock of X corporation were included in the decedent's gross estate is $5,000. The uniform basis of the entire property following the decedent's death, as reduced pursuant to this paragraph, is $12,000, computed as follows:

Uniform basis under section 1014(a), prior to reduction pursuant to this paragraph	$14,000
Less decrease in uniform basis (determined by the following formula)	2,000
[Reduction in uniform basis (to be determined)/ $5,000 (amount of reduction if paragraph (a) applied)] = [$8,000 (value of property included in gross estate/$20,000 (value of entire property)]	
Uniform basis under section 1014(a) reduced pursuant to this paragraph	12,000

(c) *Estate tax valuation date*. For purposes of section 1014(d) and this section, the estate tax valuation date is the date of the decedent's death or, in the case of an election under section 2032, the applicable valuation date prescribed by that section.

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

Example 1. At the date of A's death, his DISC stock has a fair market value of $100. The estate does not elect the alternate valuation allowed by section 2032, and A's basis in such stock is $60 at the date of his death. The person who acquires such stock from the decedent will take as a basis for such stock its fair market value at A's death ($100), reduced by the amount which would have been included in A's gross income under section 995(c) as a dividend if A had sold stock on the date he died. Thus, if the amount that would have been treated as a dividend under section 995(c) were $30, such person will take a basis of $70 for such stock ($100, reduced by $30). If such person were immediately to sell the DISC stock so received for $100, $30 of the proceeds from the sale would be treated as a dividend by such person under section 995(c).

Example 2. Assume the same facts as in example (1) except that the estate elects the alternate valuation allowed by section 2032, the DISC stock has a fair market value of $140 on the alternate valuation date, the amount that would have been treated as a dividend under section 995(c) in the event of a sale on such date is $50 and the DISC has $20 of previously taxed income which accrued after the date of the decedent's death and before the alternate valuation date. The basis of the person who acquires such stock will be $90 determined as follows:

(1) Fair market value of DISC stock at alternate valuation date	$140
(2) Less: Amount which would have been treated as a dividend under section 995(c)	50
(3) Basis of person who acquires DISC stock	90

If a distribution of $20 attributable to such previously taxed income had been made by the DISC on or before the alternate valuation date (with the DISC stock having a fair market value of $120 after such distribution), the basis of the person who acquires such stock will be $70 determined as follows:

(1) Fair market value of DISC stock at alternate valuation date	$120
(2) Less: Amount which would have been treated as a dividend under section 995(c)	50
(3) Basis of person who acquires DISC stock	70

[T.D. 7283, 38 FR 20825, Aug. 3, 1973]

§ 1.1015–1 Basis of property acquired by gift after December 31, 1920.

(a) *General rule.* (1) In the case of property acquired by gift after December 31, 1920 (whether by a transfer in trust or otherwise), the basis of the property for the purpose of determining gain is the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. The same rule applies in determining loss unless the basis (adjusted for the period prior to the date of gift in accordance with sections 1016 and 1017) is greater than the fair market value of the property at the time of the gift. In such case, the basis for determining loss is the fair market value at the time of the gift.

(2) The provisions of subparagraph (1) of this paragraph may be illustrated by the following example.

Example: A acquires by gift income-producing property which has an adjusted basis of $100,000 at the date of gift. The fair market value of the property at the date of gift is $90,000. A later sells the property for $95,000. In such case there is neither gain nor loss. The basis for determining loss is $90,000; therefore, there is no loss. Furthermore, there is no gain, since the basis for determining gain is $100,000.

(3) If the facts necessary to determine the basis of property in the hands of the donor or the last preceding owner by whom it was not acquired by gift are unknown to the donee, the district director shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the district director finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the district director as of the date or approximate date at which, according to the best information the district director is able to obtain, such property was acquired by such donor or last preceding owner. See paragraph (e) of this section for rules relating to fair market value.

(b) *Uniform basis; proportionate parts of.* Property acquired by gift has a single or uniform basis although more than one person may acquire an interest in such property. The uniform basis of the property remains fixed subject to proper adjustment for items under sections 1016 and 1017. However, the value of the proportionate parts of the uniform basis represented, for instance, by the respective interests of the life tenant and remainderman are adjustable to reflect the change in the relative values of such interest on account of the lapse of time. The portion of the basis attributable to an interest at the time of its sale or other disposition shall be determined under the rules provided in § 1.1014–5. In determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in § 1.1001–1(f)(2)) the adjusted basis of which is determined pursuant, or by reference, to section 1015, that part of the adjusted uniform basis assignable under the rules of § 1.1014–5(a) to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by section 1001(e) and § 1.1001–1(f).

(c) *Time of acquisition.* The date that the donee acquires an interest in property by gift is when the donor relinquishes dominion over the property and not necessarily when title to the property is acquired by the donee. Thus, the date that the donee acquires an interest in property by gift where he is a successor in interest, such as in the case of a remainderman of a life estate or a beneficiary of the distribution of the corpus of a trust, is the date such interests are created by the donor and not the date the property is actually acquired.

(d) *Property acquired by gift from a decedent dying after December 31, 1953.* If an interest in property was acquired by the taxpayer by gift from a donor dying after December 31, 1953, under conditions which required the inclusion of the property in the donor's gross estate for estate tax purposes, and the property had not been sold, exchanged, or otherwise disposed of by the taxpayer before the donor's death, see the rules prescribed in section 1014 and the regulations thereunder.

(e) *Fair market value.* For the purposes of this section, the value of property as appraised for the purpose of the Federal gift tax, or, if the gift is not subject to such tax, its value as appraised for the purpose of a State gift

tax, shall be deemed to be the fair market value of the property at the time of the gift.

(f) *Reinvestments by fiduciary*. If the property is an investment by the fiduciary under the terms of the gift (as, for example, in the case of a sale by the fiduciary of property transferred under the terms of the gift, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the basis specified in paragraph (a) of this section.

(g) *Records*. To insure a fair and adequate determination of the proper basis under section 1015, persons making or receiving gifts of property should preserve and keep accessible a record of the facts necessary to determine the cost of the property and, if pertinent, its fair market value as of March 1, 1913, or its fair market value as of the date of the gift.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6693, 28 FR 12818, Dec. 3, 1963; T.D. 7142, 36 FR 18952, Sept. 24, 1971]

§ 1.1015–2 Transfer of property in trust after December 31, 1920.

(a) *General rule*. (1) In the case of property acquired after December 31, 1920, by transfer in trust (other than by a transfer in trust by a gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by a transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to the termination of the trust and distribution of the property, or thereafter.

(2) The principles stated in paragraph (b) of § 1.1015–1 concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by transfer in trust after December 31, 1920.

(b) *Reinvestment by fiduciary*. If the property is an investment made by the fiduciary (as, for example, in the case of a sale by the fiduciary of property transferred by the grantor, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the basis specified in paragraph (a) of this section.

§ 1.1015–3 Gift or transfer in trust before January 1, 1921.

(a) In the case of property acquired by gift or transfer in trust before January 1, 1921, the basis of such property is the fair market value thereof at the time of the gift or at the time of the transfer in trust.

(b) The principles stated in paragraph (b) of § 1.1015–1 concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by gift or transfer in trust before January 1, 1921. In addition, if an interest in such property was acquired from a decedent and the property had not been sold, exchanged, or otherwise disposed of before the death of the donor, the rules prescribed in section 1014 and the regulations thereunder are applicable in determining the basis of such property in the hands of the taxpayer.

§ 1.1015–4 Transfers in part a gift and in part a sale.

(a) *General rule*. Where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the sum of—

(1) Whichever of the following is the greater:

(i) The amount paid by the transferee for the property, or

(ii) The transferor's adjusted basis for the property at the time of the transfer, and

(2) The amount of increase, if any, in basis authorized by section 1015(d) for gift tax paid (see § 1.1015–5).

For determining loss, the unadjusted basis of the property in the hands of the transferee shall not be greater than the fair market value of the property at the time of such transfer. For determination of gain or loss of the transferor, see § 1.1001–1(e) and § 1.1011–2. For special rule where there has been a charitable contribution of less than a taxpayer's entire interest in property, see section 170(e)(2) and § 1.170A–4(c).

(b) *Examples.* The rule of paragraph (a) of this section is illustrated by the following examples:

Example 1. If A transfers property to his son for $30,000, and such property at the time of the transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son is $30,000.

Example 2. If A transfers property to his son for $60,000, and such property at the time of transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Example 3. If A transfers property to his son for $30,000, and such property at the time of transfer has an adjusted basis in A's hands of $60,000 (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Example 4. If A transfers property to his son for $30,000 and such property at the time of transfer has an adjusted basis of $90,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son ins $90,000. However, since the adjusted basis of the property in A's hands at the time of the transfer was greater than the fair market value at that time, for the purpose of determining any loss on a later sale or other disposition of the property by the son its unadjusted basis in his hands is $60,000.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6693, 28 FR 12818, Dec. 3, 1963; T.D. 7207, 37 FR 20799, Oct. 5, 1972]

§ 1.1015–5 Increased basis for gift tax paid.

(a) *General rule in the case of gifts made on or before December 31, 1976.* (1)(i) Subject to the conditions and limitations provided in section 1015(d), as added by the Technical Amendments Act of 1958, the basis (as determined under section 1015(a) and paragraph (a) of § 1.1015–1) of property acquired by gift is increased by the amount of gift tax paid with respect to the gift of such property. Under section 1015(d)(1)(A), such increase in basis applies to property acquired by gift on or after September 2, 1958 (the date of enactment of the Technical Amendments Act of 1958). Under section 1015(d)(1)(B), such increase in basis applies to property acquired by gift before September 2, 1958, and not sold, exchanged, or otherwise disposed of before such date. If section 1015(d)(1)(A) applies, the basis of the property is increased as of the date of the gift regardless of the date of payment of the gift tax. For example, if the property was acquired by gift on September 8, 1958, and sold by the donee on October 15, 1958, the basis of the property would be increased (subject to the limitation of section 1015(d)) as of September 8, 1958 (the date of the gift), by the amount of gift tax applicable to such gift even though such tax was not paid until March 1, 1959. If section 1015(d)(1)(B) applies, any increase in the basis of the property due to gift tax paid (regardless of date of payment) with respect to the gift is made as of September 2, 1958. Any increase in basis under section 1015(d) can be no greater than the amount by which the fair market value of the property at the time of the gift exceeds the basis of such property in the hands of the donor at the time of the gift. See paragraph (b) of this section for rules for determining the amount of gift tax paid in respect of property transferred by gift.

(ii) With respect to property acquired by gift before September 2, 1958, the provisions of section 1015(d) and this section do not apply if, before such date, the donee has sold, exchanged, or otherwise disposed of such property. The phrase *sold, exchanged, or otherwise disposed of* includes the surrender of a stock certificate for corporate assets in complete or partial liquidation of a corporation pursuant to section 331. It also includes the exchange of property for property of a like kind such as the exchange of one apartment house for another. The phrase does not, however, extend to transactions which are mere changes in form. Thus, it does not include a transfer of assets to a corporation in exchange for its stock in a transaction with respect to which no gain or loss would be recognizable for income tax purposes under section 351. Nor does it include an exchange of stock or securities in a corporation for stock or securities in the same corporation or another corporation in a transaction such as a merger, recapitalization, reorganization, or other transaction described in section 368(a) or 355, with respect to which no gain or loss is recognizable for income tax purposes under section 354 or 355. If a binding contract for the sale, exchange, or other disposition of property is entered

into, the property is considered as sold, exchanged, or otherwise disposed of on the effective date of the contract, unless the contract is not subsequently carried out substantially in accordance with its terms. The effective date of a contract is normally the date it is entered into (and not the date it is consummated, or the date legal title to the property passes) unless the contract specifies a different effective date. For purposes of this subdivision, in determining whether a transaction comes within the phrase *sold, exchanged, or otherwise disposed of*, if a transaction would be treated as a mere change in the form of the property if it occurred in a taxable year subject to the Internal Revenue Code of 1954, it will be so treated if the transaction occurred in a taxable year subject to the Internal Revenue Code of 1939 or prior revenue law.

(2) Application of the provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. In 1938, A purchased a business building at a cost of $120,000. On September 2, 1958, at which time the property had an adjusted basis in A's hands of $60,000, he gave the property to his nephew, B. At the time of the gift to B, the property had a fair market value of $65,000 with respect to which A paid a gift tax in the amount of $7,545. The basis of the property in B's hands at the time of the gift, as determined under section 1015(a) and § 1.1015–1, would be the same as the adjusted basis in A's hands at the time of the gift, or $60,000. Under section 1015(d) and this section, the basis of the building in B's hands as of the date of the gift would be increased by the amount of the gift tax paid with respect to such gift, limited to an amount by which the fair market value of the property at the time of the gift exceeded the basis of the property in the hands of A at the time of gift, or $5,000. Therefore, the basis of the property in B's hands immediately after the gift, both for determining gain or loss on the sale of the property, would be $65,000.

Example 2. C purchased property in 1938 at a cost of $100,000. On October 1, 1952, at which time the property had an adjusted basis of $72,000 in C's hands, he gave the property to his daughter, D. At the date of the gift to D, the property had a fair market value of $85,000 with respect to which C paid a gift tax in the amount of $11,745. On September 2, 1958, D still held the property which then had an adjusted basis in her hands of $65,000. Since the excess of the fair market value of the property at the time of the gift to D over the adjusted basis of the property in C's hands at such time is greater than the amount of gift tax paid, the basis of the property in D's hands would be increased as of September 2, 1958, by the amount of the gift tax paid, or $11,745. The adjusted basis of the property in D's hands, both for determining gain or loss on the sale of the property, would then be $76,745 ($65,000 plus $11,745).

Example 3. On December 31, 1951, E gave to his son, F, 500 shares of common stock of the X Corporation which shares had been purchased earlier by E at a cost of $100 per share, or a total cost of $50,000. The basis in E's hands was still $50,000 on the date of the gift to F. On the date of the gift, the fair market value of the 500 shares was $80,000 with respect to which E paid a gift tax in the amount of $10,695. In 1956, the 500 shares of X Corporation stock were exchanged for 500 shares of common stock of the Y Corporation in a reorganization with respect to which no gain or loss was recognized for income tax purposes under section 354. F still held the 500 shares of Y Corporation stock on September 2, 1958. Under such circumstances, the 500 shares of X Corporation stock would not, for purposes of section 1015(d) and this section, be considered as having been *sold, exchanged, or otherwise disposed of* by F before September 2, 1958. Therefore, the basis of the 500 shares of Y Corporation stock held by F as of such date would, by reason of section 1015(d) and this section, be increased by $10,695, the amount of gift tax paid with respect to the gift to F of the X Corporation stock.

Example 4. On November 15, 1953, G gave H property which had a fair market value of $53,000 and a basis in the hands of G of $20,000. G paid gift tax of $5,250 on the transfer. On November 16, 1956, H gave the property to J who still held it on September 2, 1958. The value of the property on the date of the gift to J was $63,000 and H paid gift tax of $7,125 on the transfer. Since the property was not sold, exchanged, or otherwise disposed of by J before September 2, 1958, and the gift tax paid on the transfer to J did not exceed $43,000 ($63,000, fair market value of property at time of gift to J, less $20,000, basis of property in H's hands at that time), the basis of property in his hands is increased on September 2, 1958, by $7,125, the amount of gift tax paid by H on the transfer. No increase in basis is allowed for the $5,250 gift tax paid by G on the transfer to H, since H had sold, exchanged, or otherwise disposed of the property before September 2, 1958.

(b) *Amount of gift tax paid with respect to gifts made on or before December 31, 1976.* (1)(i) If only one gift was made during a certain *calendar period* (as defined in § 25.2502–1(c)(1)), the entire

amount of the gift tax paid under chapter 12 or the corresponding provisions of prior revenue laws for that calendar period is the amount of the gift tax paid with respect to the gift.

(ii) If more than one gift was made during a certain calendar period, the amount of the gift tax paid under chapter 12 or the corresponding provisions of prior revenue laws with respect to any specified gift made during that calendar period is an amount, A, which bears the same ratio to B (the total gift tax paid for that calendar period) as C (the *amount of the gift,* computed as described in this paragraph (b)(1)(ii)) bears to D (the total taxable gifts for the calendar period computed without deduction for the gift tax specific exemption under section 2521 (as in effect prior to its repeal by the Tax Reform Act of 1976) or the corresponding provisions of prior revenue laws). Stated algebraically, the amount of the gift tax paid with respect to a gift equals:

[*Amount of the gift* (C) / TOTAL TAXABLE GIFTS, PLUS SPECIFIC EXEMPTION ALLOWED (D)] × TOTAL GIFT TAX PAID (B)

For purposes of the ratio stated in the preceding sentence, the *amount of the gift* referred to as factor ''C'' is the value of the gift reduced by any portion excluded or deducted under section 2503(b) (annual exclusion), 2522 (charitable deduction), or 2523 (marital deduction) of the Code or the corresponding provisions of prior revenue laws. In making the computations described in this paragraph, the values to be used are those finally determined for purposes of the gift tax.

(iii) If a gift consists of more than one item of property, the gift tax paid with respect to each item shall be computed by allocating to each item a proportionate part of the gift tax paid with respect to the gift, computed in accordance with the provisions of this paragraph.

(2) For purposes of this paragraph, it is immaterial whether the gift tax is paid by the donor or the donee. Where more than one gift of a present interest in property is made to the same donee during a *calendar period* (as defined in § 25.2502–1(c)(1)), the annual exclusion shall apply to the earliest of such gifts in point of time.

(3) Where the donor and his spouse elect under section 2513 or the corresponding provisions of prior law to have any gifts made by either of them considered as made one-half by each, the amount of gift tax paid with respect to such a gift is the sum of the amounts of tax (computed separately) paid with respect to each half of the gift by the donor and his spouse.

(4) The method described in section 1015(d)(2) and this paragraph for computing the amount of gift tax paid in respect of a gift may be illustrated by the following examples:

Example 1. Prior to 1959 H made no taxable gifts. On July 1, 1959, he made a gift to his wife, W, of land having a value for gift purposes of $60,000 and gave to his son, S, certain securities valued at $60,000. During the year 1959, H also contributed $5,000 in cash to a charitable organization described in section 2522. H filed a timely gift tax return for 1959 with respect to which he paid gift tax in the amount of $6,000, computed as follows:

Value of land given to W		$60,000	
Less: Annual exclusion	$3,000		
Marital deduction	30,000	33,000	
Included amount of gift			$27,000
Value of securities given to S		60,000	
Less: Annual exclusion		3,000	
Included amount of gift			57,000
Gift to charitable organization		5,000	
Less: Annual exclusion	3,000		
Charitable deduction	2,000	5,000	
Included amount of gift			0
Total included gifts			84,000
Less: Specific exemption allowed			30,000
Taxable gifts for 1959			54,000
Gift tax on $54,000			6,000

In determining the gift tax paid with respect to the land given to W, amount C of the ratio set forth in subparagraph (1)(ii) of this paragraph is $60,000, value of property given to W, less $33,000 (the sum of $3,000, the amount excluded under section 2503(b), and $30,000, the amount deducted under section 2523), or $27,000. Amount D of the ratio is $84,000 (the amount of taxable gifts, $54,000, plus the gift tax specific exemption, $30,000). The gift tax paid with respect to the land given to W is $1,928.57, computed as follows:

$27,000(C) ÷ $84,000(D) × $6,000(B)

Example 2. The facts are the same as in example (1) except that H made his gifts to W and S on July 1, 1971, and that prior to 1971, H made no taxable gifts. Furthermore, H made his charitable contribution on August 12, 1971. These were the only gifts made by H during 1971. H filed his gift tax return for the third quarter of 1971 on November 15, 1971, as required by section 6075(b). With respect to the above gifts H paid a gift tax in the amount of $6,000 on total taxable gifts of $54,000 for the third quarter of 1971. The gift tax paid with respect to the land given to W is $1,928.57. The computations for these figures are identical to those used in example (1).

Example 3. On January 15, 1956, A made a gift to his nephew, N, of land valued at $86,000, and on June 30, 1956, gave N securities valued at $40,000. On July 1, 1956, A gave to his sister, S, $46,000 in cash. A and his wife, B, were married during the entire calendar year 1956. The amount of A's taxable gifts for prior years was zero although in arriving at that amount A had used in full the specific exemption authorized by section 2521. B did not make any gifts before 1956. A and B elected under section 2513 to have all gifts made by either during 1956 treated as made one-half by A and one-half by B. Pursuant to that election, A and B each filed a gift tax return for 1956. A paid gift tax of $11,325 and B paid gift tax of $5,250, computed as follows:

	A	B
Value of land given to N	$43,000	$43,000
Less: exclusion	3,000	3,000
Included amount of gift	40,000	40,000
Value of securities given to N	20,000	20,000
Less: exclusion	None	None
Included amount of gift	20,000	20,000
Cash gift to S	23,000	23,000
Less: exclusion	3,000	3,000
Included amount of gift	20,000	20,000
Total included gifts	80,000	80,000
Less: specific exemption	None	30,000
Taxable gifts for 1956	80,000	50,000
Gift tax for 1956	11,325	5,250

The amount of the gift tax paid by A with respect to the land given to N is computed as follows:

$40,000(C) / $80,000(D) × $11,325(B) = $5,662.50

The amount of the gift tax paid by B with respect to the land given to N is computed as follows:

$40,000(C) / $80,000(D) × $5,250(B) = $2,625

The amount of the gift tax paid with respect to the land is $5,662.50 plus $2,625, or $8,287.50. Computed in a similar manner, the amount of gift tax paid by A with respect to the securities given to N is $2,831.25, and the amount of gift tax paid by B with respect thereto is $1,312.50, or a total of $4,143.75.

Example 4. The facts are the same as in example (3) except that A gave the land to N on January 15, 1972, the securities to N on February 3, 1972, and the cash to S on March 7, 1972. As in example (3), the amount of A's taxable gifts for taxable years prior to 1972 was zero, although in arriving at that amount A had used in full the specific exemption authorized by section 2521. B did not make any gifts before 1972. Pursuant to the election under section 2513, A and B treated all gifts made by either during 1972 as made one-half by A and one-half by B. A and B each filed a gift tax return for the first quarter of 1972 on May 15, 1972, as required by section 6075(b). A paid gift tax of $11,325 on taxable gifts of $80,000 and B paid gift tax of $5,250 on taxable gifts of $50,000. The amount of the gift tax paid by A and B with respect to the land given to N is $5,662.50 and $2,625, respectively. The computations for these figures are identical to those used in example (3).

(c) *Special rule for increased basis for gift tax paid in the case of gifts made after December 31, 1976*—(1) *In general.* With respect to gifts made after December 31, 1976 (other than gifts between spouses described in section 1015(e)), the increase in basis for gift tax paid is determined under section 1015(d)(6). Under section 1015(d)(6)(A), the increase in basis with respect to gift tax paid is limited to the amount (not in excess of the amount of gift tax paid) that bears the same ratio to the amount of gift tax paid as the net appreciation in value of the gift bears to the amount of the gift.

(2) *Amount of gift.* In general, for purposes of section 1015(d)(6)(A)(ii), the amount of the gift is determined in conformance with the provisions of paragraph (b) of this section. Thus, the amount of the gift is the amount included with respect to the gift in determining (for purposes of section 2503(a)) the total amount of gifts made during the calendar year (or calendar quarter in the case of a gift made on or before December 31, 1981), reduced by the amount of any annual exclusion allowable with respect to the gift under section 2503(b), and any deductions allowed with respect to the gift under

section 2522 (relating to the charitable deduction) and section 2523 (relating to the marital deduction). Where more than one gift of a present interest in property is made to the same donee during a calendar year, the annual exclusion shall apply to the earliest of such gifts in point of time.

(3) *Amount of gift tax paid with respect to the gift.* In general, for purposes of section 1015(d)(6), the amount of gift tax paid with respect to the gift is determined in conformance with the provisions of paragraph (b) of this section. Where more than one gift is made by the donor in a calendar year (or quarter in the case of gifts made on or before December 31, 1981), the amount of gift tax paid with respect to any specific gift made during that period is the amount which bears the same ratio to the total gift tax paid for that period (determined after reduction for any gift tax unified credit available under section 2505) as the amount of the gift (computed as described in paragraph (c)(2) of this section) bears to the total taxable gifts for the period.

(4) *Qualified domestic trusts.* For purposes of section 1015(d)(6), in the case of a qualified domestic trust (QDOT) described in section 2056A(a), any distribution during the noncitizen surviving spouse's lifetime with respect to which a tax is imposed under section 2056A(b)(1)(A) is treated as a transfer by gift, and any estate tax paid on the distribution under section 2056A(b)(1)(A) is treated as a gift tax. The rules under this paragraph apply in determining the extent to which the basis in the assets distributed is increased by the tax imposed under section 2056A(b)(1)(A).

(5) *Examples.* Application of the provisions of this paragraph (c) may be illustrated by the following examples:

Example 1. (i) Prior to 1995, X exhausts X's gift tax unified credit available under section 2505. In 1995, X makes a gift to X's child Y, of a parcel of real estate having a fair market value of $100,000. X's adjusted basis in the real estate immediately before making the gift was $70,000. Also in 1995, X makes a gift to X's child Z, of a painting having a fair market value of $70,000. X timely files a gift tax return for 1995 and pays gift tax in the amount of $55,500, computed as follows:

Value of real estate transferred to Y	$100,000	.....
Less: Annual exclusion	10,000	.....
Included amount of gift (C)	.....	$90,000
Value of painting transferred to Z	$70,000	.....
Less: annual exclusion	10,000	.....
Included amount of gift	.....	60,000
Total included gifts (D)	.....	$150,000
Total gift tax liability for 1995 gifts (B)	.....	$55,500

(ii) The gift tax paid with respect to the real estate transferred to Y, is determined as follows:

$$\frac{\$90{,}000\ (C)}{\$150{,}000\ (D)} \times \$55{,}500\ (B) = \$33{,}300$$

(iii)(A) The amount by which Y's basis in the real property is increased is determined as follows:

$$\frac{\$30{,}000\ \text{(net appreciation)}}{\$90{,}000\ \text{(amount of gift)}} \times \$33{,}300 = \$11{,}100$$

(B) Y's basis in the real property is $70,000 plus $11,100, or $81,100. If X had not exhausted any of X's unified credit, no gift tax would have been paid and, as a result, Y's basis would not be increased.

Example 2. (i) X dies in 1995. X's spouse, Y, is not a United States citizen. In order to obtain the marital deduction for property passing to X's spouse, X established a QDOT in X's will. In 1996, the trustee of the QDOT makes a distribution of principal from the QDOT in the form of shares of stock having a fair market value of $70,000 on the date of distribution. The trustee's basis in the stock (determined under section 1014) is $50,000. An estate tax is imposed on the distribution under section 2056A(b)(1)(A) in the amount $38,500, and is paid. Y's basis in the shares of stock is increased by a portion of the section 2056A estate tax paid determined as follows:

$$\frac{\$20{,}000\ \text{(net appreciation)}}{\$70{,}000\ \text{(distribution)}} \times \$38{,}500\ \text{(section 2056A estate tax)} = \$11{,}000$$

(ii) Y's basis in the stock is $50,000 plus $11,000, or $61,000.

(6) *Effective date.* The provisions of this paragraph (c) are effective for gifts made after August 22, 1995.

(d) *Treatment as adjustment to basis.* Any increase in basis under section 1015(d) and this section shall, for purposes of section 1016(b) (relating to adjustments to a substituted basis), be treated as an adjustment under section 1016(a) to the basis of the donee's property to which such increase applies. See paragraph (p) of § 1.1016–5.

[T.D. 6693, 28 FR 12818, Dec. 3, 1963, as amended by T.D. 7238, 37 FR 28715, Dec. 29, 1972; T.D. 7910, 48 FR 40372, Sept. 7, 1983; T.D. 8612, 60 FR 43537, Aug. 22, 1995]

§ 1.1016–1 Adjustments to basis; scope of section.

Section 1016 and §§ 1.1016–2 to 1.1016–10, inclusive, contain the rules relating to the adjustments to be made to the basis of property to determine the adjusted basis as defined in section 1011. However, if the property was acquired from a decedent before his death, see § 1.1014–6 for adjustments on account of certain deductions allowed the taxpayer for the period between the date of acquisition of the property and the date of death of the decedent. If an election has been made under the Retirement-Straight Line Adjustment Act of 1958 (26 U.S.C. 1016 note), see § 1.9001–1 for special rules for determining adjusted basis in the case of a taxpayer who has changed from the retirement to the straight-line method of computing depreciation allowances.

§ 1.1016–2 Items properly chargeable to capital account.

(a) The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a deduction in computing net or taxable income for the taxable year. For example, in the case of oil and gas wells no adjustment may be made in respect of any intangible drilling and development expense allowable as a deduction in computing net or taxable income. See the regulations under section 263(c).

(b) The application of the foregoing provisions may be illustrated by the following example:

Example: A, who makes his returns on the calendar year basis, purchased property in 1941 for $10,000. He subsequently expended $6,000 for improvements. Disregarding, for the purpose of this example, the adjustments required for depreciation, the adjusted basis of the property is $16,000. If A sells the property in 1954 for $20,000, the amount of his gain will be $4,000.

(c) Adjustments to basis shall be made for carrying charges such as taxes and interest, with respect to property (whether real or personal, improved or unimproved, and whether productive or unproductive), which the taxpayer elects to treat as chargeable to capital account under section 266, rather than as an allowable deduction. The term *taxes* for this purpose includes duties and excise taxes but does not include income taxes.

(d) Expenditures described in section 173 to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical are chargeable to capital account only in accordance with and in the manner provided in the regulations under section 173.

§ 1.1016–3 Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913.

(a) *In general*—(1) *Adjustment where deduction is claimed.* (i) For taxable periods beginning on or after January 1, 1952, the cost or other basis of property shall be decreased for exhaustion, wear and tear, obsolescence, amortization,

and depletion by the greater of the following two amounts:

(*a*) The amount allowed as deductions in computing taxable income, to the extent resulting in a reduction of the taxpayer's income taxes, or

(*b*) The amount allowable for the years involved.

See paragraph (b) of this section. Where the taxpayer makes an appropriate election the above rule is applicable for periods since February 28, 1913, and before January 1, 1952. See paragraph (d) of this section. For rule for such periods where no election is made, see paragraph (c) of this section.

(ii) The determination of the amount properly allowable for exhaustion, wear and tear, obsolescence, amortization, and depletion must be made on the basis of facts reasonably known to exist at the end of the taxable year. A taxpayer is not permitted to take advantage in a later year of the taxpayer's prior failure to take any such allowance or the taxpayer's taking an allowance plainly inadequate under the known facts in prior years. In the case of depreciation, if in prior years the taxpayer has consistently taken proper deductions under one method, the amount allowable for such prior years may not be increased, even though a greater amount would have been allowable under another proper method. For rules governing losses on retirement or disposition of depreciable property, including rules for determining basis, see § 1.167(a)–8, 1.168(i)–1(e), or 1.168(i)–8, as applicable. The application of this paragraph is illustrated by the following example (for purposes of this example, assume section 167(f)(1) as in effect on September 19, 2013, applies to taxable years beginning on or after January 1, 2014):

Example. On July 1, 2014, A, a calendar-year taxpayer, purchased and placed in service ''off-the-shelf'' computer software at a cost of $36,000. This computer software is not an amortizable section 197 intangible. Pursuant to section 167(f)(1), the useful life of the computer software is 36 months. It has no salvage value. Computer software placed in service in 2014 is not eligible for the additional first year depreciation deduction provided by section 168(k). A did not deduct any depreciation for the computer software for 2014 and deducted depreciation of $12,000 for the computer software for 2015. As a result, the total amount of depreciation allowed for the computer software as of December 31, 2015, was $12,000. However, the total amount of depreciation allowable for the computer software as of December 31, 2015, is $18,000 ($6,000 for 2014 + $12,000 for 2015). As a result, the unrecovered cost of the computer software as of December 31, 2015, is $18,000 (cost of $36,000 less the depreciation allowable of $18,000 as of December 31, 2015). Accordingly, depreciation for 2016 for the computer software is $12,000 (unrecovered cost of $18,000 divided by the remaining useful life of 18 months as of January 1, 2016, multiplied by 12 full months in 2016).

(2) *Adjustment for amount allowable where no depreciation deduction claimed.* (i) If the taxpayer has not taken a depreciation deduction either in the taxable year or for any prior taxable year, adjustments to basis of the property for depreciation allowable shall be determined by using the straight-line method of depreciation. (See § 1.1016–4 for adjustments in the case of persons exempt from income taxation.)

(ii) For taxable years beginning after December 31, 1953, and ending after August 16, 1954, if the taxpayer with respect to any property has taken a deduction for depreciation properly under one of the methods provided in section 167(b) for one or more years but has omitted the deduction in other years, the adjustment to basis for the depreciation allowable in such a case will be the deduction under the method which was used by the taxpayer with respect to that property. Thus, if A acquired property in 1954 on which he properly computed his depreciation deduction under the method described in section 167(b)(2) (the declining-balance method) for the first year of its useful life but did not take a deduction in the second and third year of the asset's life, the adjustment to basis for depreciation allowable for the second and third year will be likewise computed under the declining-balance method.

(3) *Adjustment for depletion deductions with respect to taxable years before 1932.* Where for any taxable year before the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall not exceed a depletion deduction which would have been allowable for such year if computed without reference to

discovery value or a percentage of income.

(b) *Adjustment for periods beginning on or after January 1, 1952.* The decrease required by paragraph (a) of this section for deductions in respect of any period beginning on or after January 1, 1952, shall be whichever is the greater of the following amounts:

(1) The amount allowed as deductions in computing taxable income under subtitle A of the Code or prior income tax laws and resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under subtitle A of the Code (other than chapter 2, relating to tax on self-employment income) or prior income, war-profits, or excess-profits tax laws; or

(2) The amount properly allowable as deductions in computing taxable income under subtitle A of the Code or prior income tax laws (whether or not the amount properly allowable would have caused a reduction for any taxable year of the taxpayer's taxes).

(c) *Adjustment for periods since February 28, 1913, and before January 1, 1952, where no election made.* If no election has been properly made under section 1020, or under section 113(d) of the Internal Revenue Code of 1939 (see paragraph (d) of this section), the decrease required by paragraph (a) of this section for deductions in respect of any period since February 28, 1913, and before January 1, 1952, shall be whichever of the following amounts is the greater:

(1) The amount allowed as deductions in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws;

(2) The amount properly allowable in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws.

For the purpose of determining the decrease required by this paragraph, it is immaterial whether or not the amount under subparagraph (1) of this paragraph or the amount under subparagraph (2) of this paragraph would have resulted in a reduction for any taxable year of the taxpayer's taxes.

(d) *Adjustment for periods since February 28, 1913, and before January 1, 1952, where election made.* If an election has been properly made under section 1020, or under section 113(d) of the Internal Revenue Code of 1939, the decrease required by paragraph (a) of this section for deductions in respect of any period since February 28, 1913, and before January 1, 1952, shall be whichever is the greater of the following amounts:

(1) The amount allowed as deductions in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws and resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under such chapter 1 (other than subchapter E, relating to tax on self-employment income), subchapter E, chapter 2, of the Internal Revenue Code of 1939, or prior income, war-profits, or excess-profits tax laws;

(2) The amount properly allowable as deductions in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws (whether or not the amount properly allowable would have caused a reduction for any taxable year of the taxpayer's taxes).

(e) *Determination of amount allowed which reduced taxpayer's taxes.* (1) As indicated in paragraphs (b) and (d) of this section, there are situations in which it is necessary to determine (for the purpose of ascertaining the basis adjustment required by paragraph (a) of this section) the extent to which the amount allowed as deductions resulted in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2 relating to tax on self-employment income) of the Code, or prior income, war-profits, or excess-profits tax laws. This amount (amount allowed which resulted in a reduction of the taxpayer's taxes) is hereinafter referred to as the *tax-benefit amount allowed.* For the purpose of determining whether the tax-benefit amount allowed exceeded the amount allowable, a determination must be made of that portion of the excess of the amount allowed over the amount allowable which, if disallowed, would not have resulted in an increase in any such tax previously determined. If the entire excess of the amount allowed over the amount allowable could be disallowed without any such increase in tax, the

tax-benefit amount allowed shall not be considered to have exceeded the amount allowable. In such a case (if paragraph (b) or (d) of this section is applicable) the reduction in basis required by paragraph (a) of this section would be the amount properly allowable as a deduction. If only part of such excess could be disallowed without any such increase in tax, the tax-benefit amount allowed shall be considered to exceed the amount allowable to the extent of the remainder of such excess. In such a case (if paragraph (b) or (d) of this section is applicable), the reduction in basis required by paragraph (a) of this section would be the amount of the tax-benefit amount allowed.

(2) For the purpose of determining the tax-benefit amount allowed the tax previously determined shall be determined under the principles of section 1314. The only adjustments made in determining whether there would be an increase in tax shall be those resulting from the disallowance of the amount allowed. The taxable years for which the determination is made shall be the taxable year for which the deduction was allowed and any other taxable year which would be affected by the disallowance of such deduction. Examples of such other taxable years are taxable years to which there was a carryover or carryback of a net operating loss from the taxable year for which the deduction was allowed, and taxable years for which a computation under section 111 or section 1333 was made by reference to the taxable year for which the deduction was allowed. In determining whether the disallowance of any part of the deduction would not have resulted in an increase in any tax previously determined, proper adjustment must be made for previous determinations under section 1311, or section 3801 of the Internal Revenue Code of 1939, and for any previous application of section 1016(a)(2)(B), or section 113(b) (1)(B)(ii) of the Internal Revenue Code of 1939.

(3) If a determination under section 1016(a)(2)(B) must be made with respect to several properties for each of which the amount allowed for the taxable year exceeded the amount allowable, the tax-benefit amount allowed with respect to each of such properties shall be an allocated portion of the tax-benefit amount allowed determined by reference to the sum of the amounts allowed and the sum of the amounts allowable with respect to such several properties.

(4) In the case of property held by a partnership or trust, the computation of the tax-benefit amount allowed shall take into account the tax benefit of the partners or beneficiaries, as the case may be, from the deduction by the partnership or trust of the amount allowed to the partnership or the trust. For this purpose, the determination of the amount allowed which resulted in a tax benefit to the partners or beneficiaries shall be made in the same manner as that provided above with respect to the taxes of the person holding the property.

(5) A taxpayer seeking to limit the adjustment to basis to the tax-benefit amount allowed for any period, in lieu of the amount allowed, must establish the tax-benefit amount allowed. A failure of adequate proof as to the tax-benefit amount allowed with respect to one period does not preclude the taxpayer from limiting the adjustment to basis to the tax-benefit amount allowed with respect to another period for which adequate proof is available. For example, a corporate transferee may have available adequate records with respect to the tax effect of the deduction of erroneous depreciation for certain taxable years, but may not have available adequate records with respect to the deduction of excessive depreciation for other taxable years during which the property was held by its transferor. In such case the corporate transferee shall not be denied the right to apply this section with respect to the erroneous depreciation for the period for which adequate proof is available.

(f) *Determination of amount allowable in prior taxable years.* (1) One of the factors in determining the adjustment to basis as of any date is the amount of depreciation, depletion, etc., allowable for periods prior to such date. The amount allowable for such prior periods is determined under the law applicable to such prior periods; all adjustments required by the law applicable to such periods are made in determining

the adjusted basis of the property for the purpose of determining the amount allowable. Provisions corresponding to the rules in section 1016(a)(2)(B) described in paragraphs (d) and (e) of this section, which limit adjustments to the *tax-benefit amount allowed* where an election is properly exercised, were first enacted by the Act of July 14, 1952 (66 Stat. 629). That law provided that corresponding rules are deemed to be includible in all revenue laws applicable to taxable years ending after December 31, 1931. Accordingly, those rules shall be taken into account in determining the amount of depreciation, etc., allowable for any taxable year ending after December 31, 1931. For example, if the adjusted basis of property held by the taxpayer since January 1, 1930, is determined as of January 1, 1955, and if an election was properly made under section 1020, or section 113(d) of the Internal Revenue Code of 1939, then the amount allowable which is taken into account in computing the adjusted basis as of January 1, 1955, shall be determined by taking those rules into account for all taxable years ending after December 31, 1931. The Act of July 14, 1952, made no change in the law applicable in determining the amount allowable for taxable years ending before January 1, 1932. If there was a final decision of a court prior to the enactment of the Act of July 14, 1952, determining the amount allowable for a particular taxable year, such determination shall be adjusted. In such case the adjustment shall be made only for the purpose of taking the provision of that law into account and only to the extent made necessary by such provisions.

(2) Although the Act of July 14, 1952, amended the law applicable to all taxable years ending after December 31, 1931, the amendment does not permit refund, credit, or assessment of a deficiency for any taxable year for which such refund, credit, or assessment was barred by any law or rule of law.

(g) *Property with transferred basis.* The following rules apply in the determination of the adjustments to basis of property in the hands of a transferee, donee, or grantee which are required by section 1016(b), or section 113(b)(2) of the Internal Revenue Code of 1939, with respect to the period the property was held by the transferor, donor, or grantor:

(1) An election or a revocation of an election under section 1020, or section 113(d) of the Internal Revenue Code of 1939, by a transferor, donor, or grantor, which is made after the date of the transfer, gift, or grant of the property shall not affect the basis of such property in the hands of the transferee, donee, or grantee. An election or a revocation of an election made before the date of the transfer, gift, or grant of the property shall be taken into account in determining under section 1016(b) the adjustments to basis of such property as of the date of the transfer, gift, or grant, whether or not an election or a revocation of an election under section 1020, or section 113(d) of the Internal Revenue Code of 1939, was made by the transferee, donee, or grantee.

(2) An election by the transferee, donee, or grantee or a revocation of such an election shall be applicable in determining the adjustments to basis for the period during which the property was held by the transferor, donor, or grantor, whether or not the transferor, donor, or grantor had made an election or a revocation of an election, provided that the property was held by the transferee, donee, or grantee at any time on or before the date on which the election or revocation was made.

(h) *Application to a change in method of accounting.* For purposes of determining whether a change in depreciation or amortization for property subject to section 167, 168, 197, 1400I, 1400L(c), to section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121) (former section 168), or to an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d)) is a change in method of accounting under section 446(e) and the regulations under section 446(e), section 1016(a)(2) does not permanently affect a taxpayer's lifetime income.

(i) *Examples.* The application of section 1016(a) (1) and (2) may be illustrated by the following examples:

Example 1. The case of Corporation A discloses the following facts:

The cost or other basis is to be adjusted by $16,500 with respect to the years 1952–54, that is, by the amount allowable but not less than the amount allowed which reduced the taxpayer's taxes. An adjustment must also be made with respect to the years 1949–1951, the amount of such adjustment depending upon whether an election was properly made under section 1020, or section 113(d) of the Internal Revenue Code of 1939. If no such election was made, the amount of the adjustment with respect to the years 1949–1951 is $19,500, that is, the amount allowed but not less than the amount allowable. If an election was properly made, the amount of the adjustment with respect to the years 1949–1951 is $19,000, that is, the amount allowable but not less than the amount allowed which reduced the taxpayer's taxes.

(1)—Year	(2)—Amount allowed	(3)—Amount allowed which reduced taxpayer's taxes	(4)—Amount allowable	(5)—Amount allowable but not less than amount allowed	(6)—Amount allowable but not less than amount allowed which reduced taxpayer's taxes
1949	$6,000	$5,500	$5,000	$6,000	$5,500
1950	7,000	7,000	6,500	7,000	7,000
1951	5,000	4,000	6,500	6,500	6,500
Total, 1949–1951				19,500	19,000
1952	6,500	6,500	6,000		6,500
1953	5,000	4,000	4,000		4,000
1954	4,500	4,500	6,000		6,000
Total, 1952–1954					16,500

Example 2. Corporation A, which files its returns on the basis of a calendar year, purchased a building on January 1, 1950, at a cost of $100,000. On the basis of the facts reasonably known to exist at the end of 1950, a period of 50 years should have been used as the correct useful life of the building; nevertheless, depreciation was computed by Corporation A on the basis of a useful life of 25 years, and was allowed for 1950 through 1953 as a deduction in an annual amount of $4,000. The building was sold on January 1, 1954. Corporation A did not make an election under section 1020, or section 113(d) of the Internal Revenue Code of 1939. No part of the amount allowed Corporation A for any of the years 1950 through 1953 resulted in a reduction of Corporation A's taxes. The adjusted basis of the building as of January 1, 1954, is $88,166, computed as follows:

Taxable year	Adjustments to basis as of beginning of taxable year	Adjusted basis on January 1	Remaining life on January 1	Depreciation allowable	Depreciation allowed
1950		$100,000	50	$2,000	$4,000
1951	$4,000	96,000	49	1,959	4,000
1952	8,000	92,000	48	1,917	4,000
1953	9,917	90,083	47	1,917	4,000
1954	11,834	88,166			

Example 3. The facts are the same as in example (2), except that Corporation A made a proper election under section 1020. In such case, the adjusted basis of the building as of January 1, 1954, is $92,000 computed as follows:

Taxable year	Adjustments to basis as of beginning of taxable year	Adjusted basis on January 1	Remaining life on January 1	Depreciation allowable	Depreciation allowed
1950		$100,000	50	$2,000	$4,000
1951	$2,000	98,000	49	2,000	4,000
1952	4,000	96,000	48	2,000	4,000
1953	6,000	94,000	47	2,000	4,000
1954	8,000	92,000			

Example 4. If it is assumed that in example (2), or in example (3), all of the deduction allowed Corporation A for 1953 had resulted in a reduction of A's taxes, the adjustment to the basis of the building for depreciation for 1953 would reflect the entire $4,000 deduction. In such case, the adjusted basis of the building as of January 1, 1954, would be $86,083 in example (2), and $90,000 in example (3).

Example 5. The facts are the same as in example (2), except that for the year 1950 all of the $4,000 amount allowed Corporation A as a deduction for depreciation for that year resulted in a reduction of A's taxes. In such case, the adjustments to the basis of the building remain the same as those set forth in example (2).

Example 6. The facts are the same as in example (3), except that for the year 1950 all of the $4,000 amount allowed Corporation A as a deduction for depreciation resulted in a reduction of A's taxes. In such case, the adjusted basis of the building as of January 1, 1954, is $90,123, computed as follows:

Taxable year	Adjustments to basis as of beginning of taxable year	Adjusted basis on January 1	Remaining life on January 1	Depreciation allowable	Depreciation allowed
1950		$100,000	50	$2,000	$4,000
1951	$4,000	96,000	49	1,959	4,000
1952	5,959	94,041	48	1,959	4,000
1953	7,918	92,082	47	1,959	4,000
1954	9,877	90,123			

(j) *Effective/applicability dates*—(1) *In general.* Except as provided in paragraphs (j)(2) and (j)(3) of this section, this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.1016–3 in effect prior to December 30, 2003 (§1.1016–3 as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(2) *Depreciation or amortization changes.* Paragraph (h) of this section applies to a change in depreciation or amortization for property subject to section 167, 168, 197, 1400I, 1400L(c), to former section 168, or to an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d)) for taxable years ending on or after December 30, 2003.

(3) *Application of §1.1016–3T(a)(1)(ii)*—(i) *In general.* Paragraph (a)(1)(ii) of this section applies to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (j)(3)(ii) and (j)(3)(iii) of this section, §1.1016–3(a)(1)(ii) as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(ii) *Early application of §1.1016–3(a)(1)(ii).* A taxpayer may choose to apply paragraph (a)(1)(ii) of this section to taxable years beginning on or after January 1, 2012.

(iii) *Optional application of TD 9564.* A taxpayer may choose to apply §1.1016–3T(a)(1)(ii) as contained in TD 9564 (76 FR 81060) December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 9105, 69 FR 12, Jan. 2, 2004; T.D. 9307, Dec. 28, 2006; T.D. 9564, 76 FR 81126, Dec. 27, 2011; T.D. 9636, 78 FR 57746, Sept. 19, 2013; T.D. 9689, 79 FR 48684, Aug. 18, 2014]

§1.1016–4 Exhaustion, wear and tear, obsolescence, amortization, and depletion; periods during which income was not subject to tax.

(a) Adjustments to basis must be made for exhaustion, wear and tear, obsolescence, amortization, and depletion to the extent actually sustained in respect of:

(1) Any period before March 1, 1913,

(2) Any period since February 28, 1913, during which the property was held by a person or organization not subject to income taxation under chapter 1 of the Code or prior income tax laws,

(3) Any period since February 28, 1913, and before January 1, 1958, during which the property was held by a person subject to tax under part I, subchapter L, chapter 1 of the Code, or prior income tax law, to the extent that section 1016(a)(2) does not apply, and

(4) Any period since February 28, 1913, during which such property was held by a person subject to tax under part II of subchapter L, chapter 1 of the Code,

or prior income tax law, to the extent that section 1016(a)(2) does not apply.

(b) The amount of the adjustments described in paragraph (a) of this section actually sustained is that amount charged off on the books of the taxpayer where such amount is considered by the Commissioner to be reasonable. Otherwise, the amount actually sustained will be the amount that would have been allowable as a deduction:

(1) During the period described in paragraph (a) (1) or (2) of this section, had the taxpayer been subject to income tax during those periods, or

(2) During the period described in paragraph (a) (3) or (4) of this section, with respect to property held by a taxpayer described in that paragraph, to the extent that section 1016(a)(2) was inapplicable to such property during that period.

In the case of a taxpayer subject to the adjustment required by subparagraph (1) or (2) of this paragraph, depreciation shall be determined by using the straight line method.

[T.D. 6681, 28 FR 11131, Oct. 17, 1963]

§ 1.1016–5 Miscellaneous adjustments to basis.

(a) *Certain stock distributions.* (1) In the case of stock, the cost or other basis must be diminished by the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax free or were applicable in reduction of basis (not including distributions made by a corporation which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 (40 Stat. 1057) or the Revenue Act of 1921 (42 Stat. 227), out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or the Revenue Act of 1921). For adjustments to basis in the case of certain corporate distributions, see section 301 and the regulations thereunder.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example: A, who makes his returns upon the calendar year basis, purchased stock in 1923 for $5,000. He received in 1924 a distribution of $2,000 paid out of earnings and profits of the corporation accumulated before March 1, 1913. The adjusted basis for determining the gain or loss from the sale or other disposition of the stock in 1954 is $5,000 less $2,000, or $3,000, and the amount of the gain or loss from the sale or other disposition of the stock is the difference between $3,000 and the amount realized from the sale or other disposition.

(b) *Amortizable bond premium*—(1) *In general.* A holder's basis in a bond is reduced by the amount of bond premium used to offset qualified stated interest income under § 1.171–2. This reduction occurs when the holder takes the qualified stated interest into account under the holder's regular method of accounting.

(2) *Special rules for taxable bonds.* A holder's basis in a taxable bond is reduced by the amount of bond premium allowed as a deduction under § 1.171–3(c)(5)(ii) (relating to the issuer's call of a taxable bond) or under § 1.171–2(a)(4)(i)(A) (relating to excess bond premium).

(3) *Special rule for tax-exempt obligations.* A holder's basis in a tax-exempt obligation is reduced by the amount of excess bond premium that is treated as a nondeductible loss under § 1.171–2(a)(4)(ii).

(c) *Municipal bonds.* In the case of a municipal bond (as defined in section 75(b)), basis shall be adjusted to the extent provided in section 75 or as provided in section 22(o) of the Internal Revenue Code of 1939, and the regulations thereunder.

(d) *Sale or exchange of residence.* Where the acquisition of a new residence results in the nonrecognition of any part of the gain on the sale, or exchange, or involuntary conversion of the old residence, the basis of the new residence shall be reduced by the amount of the gain not so recognized pursuant to section 1034(a), or section 112(n) of the Internal Revenue Code of 1939, and the regulations thereunder. See section 1034(e) and the regulations thereunder.

(e) *Loans from Commodity Credit Corporation.* In the case of property pledged to the Commodity Credit Corporation, the basis of such property shall be increased by the amount received as a loan from such corporation and treated by the taxpayer as income for the year in which received under

section 77, or under section 123 of the Internal Revenue Code of 1939. The basis of such property shall be reduced to the extent of any deficiency on such loan with respect to which the taxpayer has been relieved from liability.

(f) *Deferred development and exploration expenses.* Expenditures for development and exploration of mines or mineral deposits treated as deferred expenses under sections 615 and 616, or under the corresponding provisions of prior income tax laws, are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions which results in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2 relating to tax on self-employment income) of the Code, or prior income, war-profits, or excess-profits tax laws, but not less than the amounts allowable under such provisions for the taxable year and prior years. This amount is considered as the *tax-benefit amount allowed* and shall be determined in accordance with paragraph (e) of § 1.1016–3. For example, if a taxpayer purchases unexplored and undeveloped mining property for $1,000,000 and at the close of the development stage has incurred exploration and development costs of $9,000,000 treated as deferred expenses, the basis of such property at such time for computing gain or loss will be $10,000,000. Assuming that the taxpayer in this example has operated the mine for several years and has deducted allowable percentage depletion in the amount of $2,000,000 and has deducted allowable deferred exploration and development expenditures of $2,000,000, the basis of the property in the taxpayer's hands for purposes of determining gain or loss from a sale will be $6,000,000.

(g) *Sale of land with unharvested crop.* In the case of an unharvested crop which is sold, exchanged, or involuntarily converted with the land and which is considered as property used in the trade or business under section 1231, the basis of such crop shall be increased by the amount of the items which are attributable to the production of such crop and which are disallowed, under section 268, as deductions in computing taxable income. The basis of any other property shall be decreased by the amount of any such items which are attributable to such other property, notwithstanding any provisions of section 1016 or of this section to the contrary. For example, if the items attributable to the production of an unharvested crop consist only of fertilizer costing $100 and $50 depreciation on a tractor used only to cultivate such crop, and such items are disallowed under section 268, the adjustments to the basis of such crop shall include an increase of $150 for such items and the adjustments to the basis of the tractor shall incude a reduction of $50 for depreciation.

(h) *Consent dividends.* (1) In the case of amounts specified in a shareholder's consent to which section 28 of the Internal Revenue Code of 1939 applies, the basis of the consent stock shall be increased to the extent provided in subsection (h) of such section.

(2) In the case of amounts specified in a shareholder's consent to be treated as a consent dividend to which section 565 applies, the basis of the consent stock shall be increased by the amount which, under section 565(c)(2), is treated as contributed to the capital of the corporation.

(i) *Stock in foreign personal holding company.* In the case of the stock of a United States shareholder in a foreign personal holding company, basis shall be adjusted to the extent provided in section 551(f) or corresponding provisions of prior income tax laws.

(j) *Research and experimental expenditures.* Research and experimental expenditures treated as deferred expenses under section 174(b) are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions which results in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2 relating to tax on self-employment income) of the Code, or prior income, war-profits, or excess-profits tax laws, but not less than the amounts allowable under such provisions for the taxable year and prior years. This

amount is considered as the *tax-benefit amount allowed* and shall be determined in accordance with paragraph (e) of § 1.1016–3.

(k) *Deductions disallowed in connection with disposal of coal or domestic iron ore.* Basis shall be adjusted by the amount of the deductions disallowed under section 272 with respect to the disposal of coal or domestic iron ore covered by section 631.

(l) *Expenditures attributable to grants or loans covered by section 621.* In the case of expenditures attributable to a grant or loan made to a taxpayer by the United States for the encouragement of exploration for, or development or mining of, critical and strategic minerals or metals, basis shall be adjusted to the extent provided in section 621, or in section 22(b)(15) of the Internal Revenue Code of 1939.

(m) *Trademark and trade name expenditures.* Trademark and trade name expenditures treated as deferred expenses under section 177 are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions which results in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2, relating to tax on self-employment income) of the Code, but not less than the amounts allowable under such section for the taxable year and prior years. This amount is considered as the *tax-benefit amount allowed* and shall be determined in accordance with paragraph (e) of § 1.1016–3.

(n) *Life insurance companies.* In the case of any evidence of indebtedness referred to in section 818(b), the basis shall be adjusted to the extent of the adjustments required under section 818(b) (or the corresponding provisions of prior income tax laws) for the taxable year and all prior taxable years. The basis of any such evidence of indebtedness shall be reduced by the amount of the adjustment required under section 818(b) (or the corresponding provision of prior income tax laws) on account of amortizable premium and shall be increased by the amount of the adjustment required under section 818(b) on account of accruable discounts.

(o) *Stock and indebtedness of electing small business corporation.* In the case of a shareholder of an electing small business corporation, as defined in section 1371(b), the basis of the shareholder's stock in such corporation, and the basis of any indebtedness of such corporation owing to the shareholder, shall be adjusted to the extent provided in §§ 1.1375–4, 1.1376–1, and 1.1376–2.

(p) *Gift tax paid on certain property acquired by gift.* Basis shall be adjusted by that amount of the gift tax paid in respect of property acquired by gift which, under section 1015(d), is an increase in the basis of such property.

(q) *Section 38 property.* In the case of property which is or has been section 38 property (as defined in section 48(a)), the basis shall be adjusted to the extent provided in section 48(g) and in section 203(a)(2) of the Revenue Act of 1964.

(r) *Stock in controlled foreign corporations and other property.* In the case of stock in controlled foreign corporations (or foreign corporations which were controlled foreign corporations) and of property by reason of which a person is considered as owning such stock, the basis shall be adjusted to the extent provided in section 961.

(s) *Original issue discount.* In the case of certain corporate obligations issued at a discount after May 27, 1969, the basis shall be increased under section 1232(a)(3)(E) by the amount of original issue discount included in the holder's gross income pursuant to section 1232(a)(3).

(t) *Section 23 credit.* In the case of property with respect to which a credit has been allowed under section 23 or former section 44C (relating to residential energy credit), basis shall be adjusted as provided in paragraph (k) of § 1.23–3.

(u) *Gas guzzler tax.* In the case of an automobile upon which the gas guzzler tax was imposed, the basis shall be reduced as provided in section 1016 (d).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.1016–5, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.govinfo.gov*.

§ 1.1016–6 Other applicable rules.

(a) Adjustments must always be made to eliminate double deductions or their equivalent. Thus, in the case of the stock of a subsidiary company, the basis thereof must be properly adjusted for the amount of the subsidiary company's losses for the years in which consolidated returns were made.

(b) In determining basis, and adjustments to basis, the principles of estoppel apply, as elsewhere under the Code, and prior internal revenue laws.

§ 1.1016–10 Substituted basis.

(a) Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 1016(b), the adjustments indicated in §§ 1.1016–1 to 1.1016–6, inclusive, shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. In addition, whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 1016(b)(1), the adjustments indicated in §§ 1.1016–7 to 1.1016–9, inclusive, and in section 1017 shall also be made, whenever necessary, after first making in respect of such substituted basis a proper adjustment of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor. Similar rules shall also be applied in the case of a series of substituted bases.

(b)cation of this section may be illustrated by the following example:

Example: A, who makes his returns upon the calendar year basis, in 1935 purchased the X Building and subsequently gave it to his son B. B exchanged the X Building for the Y Building in a tax-free exchange, and then gave the Y Building to his wife C. C, in determining the gain from the sale or disposition of the Y Building in 1954, is required to reduce the basis of the building by deductions for depreciation which were successively allowed (but not less than the amount allowable) to A and B upon the X Building and to B upon the Y Building, in addition to the deductions for depreciation allowed (but not less than the amount allowable) to herself during her ownership of the Y Building.

§ 1.1017–1 Basis reductions following a discharge of indebtedness.

(a) *General rule for section 108(b)(2)(E).* This paragraph (a) applies to basis reductions under section 108(b)(2)(E) that are required by section 108(a)(1) (A) or (B) because the taxpayer excluded discharge of indebtedness (COD income) from gross income. A taxpayer must reduce in the following order, to the extent of the excluded COD income (but not below zero), the adjusted bases of property held on the first day of the taxable year following the taxable year that the taxpayer excluded COD income from gross income (in proportion to adjusted basis):

(1) Real property used in a trade or business or held for investment, other than real property described in section 1221(1), that secured the discharged indebtedness immediately before the discharge;

(2) Personal property used in a trade or business or held for investment, other than inventory, accounts receivable, and notes receivable, that secured the discharged indebtedness immediately before the discharge;

(3) Remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable, and real property described in section 1221(1);

(4) Inventory, accounts receivable, notes receivable, and real property described in section 1221(1); and

(5) Property not used in a trade or business nor held for investment.

(b) *Operating rules*—(1) *Prior tax-attribute reduction.* The amount of excluded COD income applied to reduce basis does not include any COD income applied to reduce tax attributes under sections 108(b)(2) (A) through (D) and, if applicable, section 108(b)(5). For example, if a taxpayer excludes $100 of COD income from gross income under section 108(a) and reduces tax attributes by $40 under sections 108(b)(2) (A) through (D), the taxpayer is required to reduce the adjusted bases of property by $60 ($100 − $40) under section 108(b)(2)(E).

(2) *Multiple discharged indebtednesses.* If a taxpayer has COD income attributable to more than one discharged indebtedness resulting in the reduction of tax attributes under sections 108(b)(2) (A) through (D) and, if applicable, section 108(b)(5), paragraph (b)(1) of this section must be applied by allocating the tax-attribute reductions among the indebtednesses in proportion to the amount of COD income attributable to each discharged indebtedness. For example, if a taxpayer excludes $20 of COD income attributable to secured indebtedness A and excludes $80 of COD income attributable to unsecured indebtedness B (a total exclusion of $100), and if the taxpayer reduces tax attributes by $40 under sections 108(b)(2) (A) through (D), the taxpayer must reduce the amount of COD income attributable to secured indebtedness A to $12 ($20 − ($20 / $100 × $40)) and must reduce the amount of COD income attributable to unsecured indebtedness B to $48 ($80 − ($80 / $100 × $40)).

(3) *Limitation on basis reductions under section 108(b)(2)(E) in bankruptcy or insolvency.* If COD income arises from a discharge of indebtedness in a title 11 case or while the taxpayer is insolvent, the amount of any basis reduction under section 108(b)(2)(E) shall not exceed the excess of—

(i) The aggregate of the adjusted bases of property and the amount of money held by the taxpayer immediately after the discharge; over

(ii) The aggregate of the liabilities of the taxpayer immediately after the discharge.

(4) *Transactions to which section 381 applies.* If a taxpayer realizes COD income that is excluded from gross income under section 108(a) either during or after a taxable year in which the taxpayer is the distributor or transferor of assets in a transaction described in section 381(a), the basis of property acquired by the acquiring corporation in the transaction must reflect the reductions required by section 1017 and this section. For this purpose, the basis of property of the distributor or transferor corporation immediately prior to the transaction described in section 381(a), but after the determination of tax for the year of the distribution or transfer of assets, will be available for reduction under section 108(b)(2). However, the basis of stock or securities of the acquiring corporation, if any, received by the taxpayer in exchange for the transferred assets shall not be available for reduction under section 108(b)(2). *See* § 1.108–7. This paragraph (b)(4) applies to discharges of indebtedness occurring on or after May 10, 2004.

(c) *Modification of ordering rules for basis reductions under sections 108(b)(5) and 108(c)*—(1) *In general.* The ordering rules prescribed in paragraph (a) of this section apply, with appropriate modifications, to basis reductions under sections 108(b)(5) and (c). Thus, a taxpayer that elects to reduce basis under section 108(b)(5) may, to the extent that the election applies, reduce only the adjusted basis of property described in paragraphs (a) (1), (2), and (3) of this section and, if an election is made under paragraph (f) of this section, paragraph (a) (4) of this section. Within paragraphs (a) (1), (2), (3) and (4) of this section, such a taxpayer may reduce only the adjusted bases of depreciable property. A taxpayer that elects to apply section 108(c) may reduce only the adjusted basis of property described in paragraphs (a) (1) and (3) of this section and, within paragraphs (a)(1) and (3) of this section, may reduce only the adjusted bases of depreciable real property. Furthermore, for basis reductions under section 108(c), a taxpayer must reduce the adjusted basis of the qualifying real property to the extent of the discharged qualified real property business indebtedness before reducing the adjusted bases of other depreciable real property. The term *qualifying real property* means real property with respect to which the indebtedness is qualified real property business indebtedness within the meaning of section 108(c)(3). See paragraphs (f) and (g) of this section for elections relating to section 1221(1) property and partnership interests.

(2) *Partial basis reductions under section 108(b)(5).* If the amount of basis reductions under section 108(b)(5) is less than the amount of the COD income excluded from gross income under section 108(a), the taxpayer must reduce the balance of its tax attributes, including any remaining adjusted bases

of depreciable and other property, by following the ordering rules under section 108(b)(2). For example, if a taxpayer excludes $100 of COD income from gross income under section 108(a) and elects to reduce the adjusted bases of depreciable property by $10 under section 108(b)(5), the taxpayer must reduce its remaining tax attributes by $90, starting with net operating losses under section 108(b)(2).

(3) *Modification of fresh start rule for prior basis reductions under section 108(b)(5).* After reducing the adjusted bases of depreciable property under section 108(b)(5), a taxpayer must compute the limitation on basis reductions under section 1017(b)(2) using the aggregate of the remaining adjusted bases of property. For example, if, immediately after the discharge of indebtedness in a title 11 case, a taxpayer's adjusted bases of property is $100 and its undischarged indebtedness is $70, and if the taxpayer elects to reduce the adjusted bases of depreciable property by $10 under section 108(b)(5), section 1017(b)(2) limits any further basis reductions under section 108(b)(2)(E) to $20 (($100 − $10) − $70).

(d) *Changes in security.* If any property is added or eliminated as security for an indebtedness during the one-year period preceding the discharge of that indebtedness, such addition or elimination shall be disregarded where a principal purpose of the change is to affect the taxpayer's basis reductions under section 1017.

(e) *Depreciable property.* For purposes of this section, the term *depreciable property* means any property of a character subject to the allowance for depreciation or amortization, but only if the basis reduction would reduce the amount of depreciation or amortization which otherwise would be allowable for the period immediately following such reduction. Thus, for example, a lessor cannot reduce the basis of leased property where the lessee's obligation in respect of the property will restore to the lessor the loss due to depreciation during the term of the lease, since the lessor cannot take depreciation in respect of such property.

(f) *Election to treat section 1221(1) real property as depreciable*—(1) *In general.* For basis reductions under section 108(b)(5) and basis reductions relating to qualified farm indebtedness, a taxpayer may elect under sections 1017(b)(3)(E) and (4)(C), respectively, to treat real property described in section 1221(1) as depreciable property. This election is not available, however, for basis reductions under section 108(c).

(2) *Time and manner.* To make an election under section 1017(b) (3)(E) or (4)(C), a taxpayer must enter the appropriate information on Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment),* and attach the form to a timely filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a). An election under this paragraph (f) may be revoked only with the consent of the Commissioner.

(g) *Partnerships*—(1) *Partnership COD income.* For purposes of paragraph (a) of this section, a taxpayer must treat a distributive share of a partnership's COD income as attributable to a discharged indebtedness secured by the taxpayer's interest in that partnership.

(2) *Partnership interest treated as depreciable property*—(i) *In general.* For purposes of making basis reductions, if a taxpayer makes an election under section 108(b)(5) (or 108(c)), the taxpayer must treat a partnership interest as depreciable property (or depreciable real property) to the extent of the partner's proportionate share of the partnership's basis in depreciable property (or depreciable real property), provided that the partnership consents to a corresponding reduction in the partnership's basis (inside basis) in depreciable property (or depreciable real property) with respect to such partner.

(ii) *Request by partner and consent of partnership*—(A) *In general.* Except as otherwise provided in this paragraph (g)(2)(ii), a taxpayer may choose whether or not to request that a partnership reduce the inside basis of its depreciable property (or depreciable real property) with respect to the taxpayer, and the partnership may grant or withhold such consent, in its sole discretion. A request by the taxpayer

must be made before the due date (including extensions) for filing the taxpayer's Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a).

(B) *Request for consent required.* A taxpayer must request a partnership's consent to reduce inside basis if, at the time of the discharge, the taxpayer owns (directly or indirectly) a greater than 50 percent interest in the capital and profits of the partnership, or if reductions to the basis of the taxpayer's depreciable property (or depreciable real property) are being made with respect to the taxpayer's distributive share of COD income of the partnership.

(C) *Granting of request required.* A partnership must consent to reduce its partners' shares of inside basis with respect to a discharged indebtedness if consent is requested with respect to that indebtedness by partners owning (directly or indirectly) an aggregate of more than 80 percent of the capital and profits interests of the partnership or five or fewer partners owning (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership. For example, if there is a cancellation of partnership indebtedness that is secured by real property used in a partnership's trade or business, and if partners owning (in the aggregate) 90 percent of the capital and profits interests of the partnership elect to exclude the COD income under section 108(c), the partnership must make the appropriate reductions in those partners' shares of inside basis.

(iii) *Partnership consent statement*—(A) *Partnership requirement.* A consenting partnership must include with the Form 1065, U.S. Partnership Return of Income, for the taxable year following the year that ends with or within the taxable year the taxpayer excludes COD income from gross income under section 108(a), and must provide to the taxpayer on or before the due date of the taxpayer's return (including extensions) for the taxable year in which the taxpayer excludes COD income from gross income, a statement that—

(*1*) Contains the name, address, and taxpayer identification number of the partnership; and

(*2*) States the amount of the reduction of the partner's proportionate interest in the adjusted bases of the partnership's depreciable property or depreciable real property, whichever is applicable.

(B) *Taxpayer's requirement.* For taxable years beginning before January 1, 2003, statements described in §1.1017–1(g)(2)(iii)(A) must be attached to a taxpayer's timely filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a). For taxable years beginning after December 31, 2002, taxpayers must retain the statements and keep them available for inspection in the manner required by §1.6001–1(e), but are not required to attach the statements to their returns.

(iv) *Partner's share of partnership basis*—(A) *In general.* For purposes of this paragraph (g), a partner's proportionate share of the partnership's basis in depreciable property (or depreciable real property) is equal to the sum of—

(*1*) The partner's section 743(b) basis adjustments to items of partnership depreciable property (or depreciable real property); and

(*2*) The common basis depreciation deductions (but not including remedial allocations of depreciation deductions under §1.704–3(d)) that, under the terms of the partnership agreement effective for the taxable year in which the discharge of indebtedness occurs, are reasonably expected to be allocated to the partner over the property's remaining useful life. The assumptions made by a partnership in determining the reasonably expected allocation of depreciation deductions must be consistent for each partner. For example, a partnership may not treat the same depreciation deductions as being reasonably expected by more than one partner.

(B) *Effective date.* This paragraph (g)(2)(iv) applies to elections made under sections 108(b)(5) and 108(c) on or after December 15, 1999.

(v) *Treatment of basis reduction*—(A) *Basis adjustment.* The amount of the reduction to the basis of depreciable

partnership property constitutes an adjustment to the basis of partnership property with respect to the partner only. No adjustment is made to the common basis of partnership property. Thus, for purposes of income, deduction, gain, loss, and distribution, the partner will have a special basis for those partnership properties the bases of which are adjusted under section 1017 and this section.

(B) *Recovery of adjustments to basis of partnership property.* Adjustments to the basis of partnership property under this section are recovered in the manner described in § 1.743–1.

(C) *Effect of basis reduction.* Adjustments to the basis of partnership property under this section are treated in the same manner and have the same effect as an adjustment to the basis of partnership property under section 743(b). The following example illustrates this paragraph (g)(2)(v):

Example. (i) A, B, and C are equal partners in partnership PRS, which owns (among other things) Asset 1, an item of depreciable property with a basis of $30,000. A's basis in its partnership interest is $20,000. Under the terms of the partnership agreement, A's share of the depreciation deductions from Asset 1 over its remaining useful life will be $10,000. Under section 1017, A requests, and PRS agrees, to decrease the basis of Asset 1 with respect to A by $10,000.

(ii) In the year following the reduction of basis under section 1017, PRS amends its partnership agreement to provide that items of depreciation and loss from Asset 1 will be allocated equally between B and C. In that year, A's distributive share of the partnership's common basis depreciation deductions from Asset 1 is now $0. Under § 1.743–1(j)(4)(ii)(B), the amount of the section 1017 basis adjustment that A recovers during the year is $1,000. A will report $1,000 of ordinary income because A's distributive share of the partnership's common basis depreciation deductions from Asset 1 ($0) is insufficient to offset the amount of the section 1017 basis adjustment recovered by A during the year ($1,000).

(iii) In the following year, PRS sells Asset 1 for $15,000 and recognizes a $12,000 loss. This loss is allocated equally between B and C, and A's share of the loss is $0. Upon the sale of Asset 1, A recovers its entire remaining section 1017 basis adjustment ($9,000). A will report $9,000 of ordinary income.

(D) *Effective date.* This paragraph (g)(2)(v) applies to elections made under sections 108(b)(5) and 108(c) on or after December 15, 1999.

(3) *Partnership basis reduction.* The rules of this section (including this paragraph (g)) apply in determining the properties to which the partnership's basis reductions must be made.

(h) *Special allocation rule for cases to which section 1398 applies.* If a bankruptcy estate and a taxpayer to whom section 1398 applies (concerning only individuals under Chapter 7 or 11 of title 11 of the United States Code) hold property subject to basis reduction under section 108(b) (2)(E) or (5) on the first day of the taxable year following the taxable year of discharge, the bankruptcy estate must reduce all of the adjusted bases of its property before the taxpayer is required to reduce any adjusted bases of property.

(i) *Effective date.* This section applies to discharges of indebtedness occurring on or after October 22, 1998.

[T.D. 8787, 63 FR 56563, Oct. 22, 1998, as amended by T.D. 8847, 64 FR 69921, Dec. 15, 1999; T.D. 9080, 68 FR 42593, July 18, 2003; T.D. 9100, 68 FR 70705, Dec. 19, 2003; T.D. 9100, 69 FR 5017, Feb. 3, 2004; T.D. 9127, 69 FR 26039, May 11, 2004; T.D. 9300, 71 FR 71042, Dec. 8, 2006]

§ 1.1019–1 Property on which lessee has made improvements.

In any case in which a lessee of real property has erected buildings or made other improvements upon the leased property and the lease is terminated by forfeiture or otherwise resulting in the realization by such lessor of income which, were it not for the provisions of section 109, would be includible in gross income of the lessor, the amount so excluded from gross income shall not be taken into account in determining the basis or the adjusted basis of such property or any portion thereof in the hands of the lessor. If, however, in any taxable year beginning before January 1, 1942, there has been included in the gross income of the lessor an amount representing any part of the value of such property attributable to such buildings or improvements, the basis of each portion of such property shall be properly adjusted for the amount so included in gross income. For example, A leased in 1930 to B for a period of 25 years unimproved real property and in

accordance with the terms of the lease B erected a building on the property. It was estimated that upon expiration of the lease the building would have a depreciated value of $50,000, which value the lessor elected to report (beginning in 1931) as income over the term of the lease. This method of reporting was used until 1942. In 1952 B forfeits the lease. The amount of $22,000 reported as income by A during the years 1931 to 1941, inclusive, shall be added to the basis of the property represented by the improvements in the hands of A. If in such case A did not report during the period of the lease any income attributable to the value of the building erected by the lessee and the lease was forfeited in 1940 when the building was worth $75,000, such amount, having been included in gross income under the law applicable to that year, is added to the basis of the property represented by the improvements in the hands of A. As to treatment of such property for the purposes of capital gains and losses, see subchapter P (section 1201 and following), chapter 1 of the Code.

§ 1.1020–1 Election as to amounts allowed in respect of depreciation, etc., before 1952.

(a) *In general.* (1) Any person may elect to have the adjustments to the cost or other basis of property under section 1016(a)(2) determined in accordance with subparagraph (B) of such section by filing a statement of election in accordance with the requirements set forth in paragraph (b) of this section. Any election made after 1952 shall be irrevocable when made. Any election made after 1952 shall apply with respect to all property held by the person making the election at any time on or before December 31, 1952, and shall apply to all periods since February 28, 1913, and before January 1, 1952, during which such person held such property or for which adjustments must be made under section 1016(b). For rules with respect to an election made on or before December 31, 1952, see paragraph (c) of this section.

(2) An election by a partner on his own behalf is not an election for the partnership of which he is a member. A separate election must be made on behalf of the partnership. (See section 703(b) (relating to elections of the partnership).) An election on behalf of the partnership applies only with respect to the partnership, and does not apply to the separate property of the partners. A similar rule applies with respect to elections by trusts and beneficiaries of trusts. These rules also apply with respect to a revocation of an election where such election was made on or before December 31, 1952.

(b) *Rules applicable to making of election.* The following rules are applicable to the making of an election under section 1020:

(1) *Form of election.* The election shall be in the form of a statement in writing, shall state the name and address of the taxpayer making the election, and shall contain a statement that such taxpayer elects to have the provisions of section 1016(a)(2)(B) apply in respect of all periods since February 28, 1913, and before January 1, 1952.

(2) *Signature.* The statement shall be signed by the taxpayer making the election, if an individual, or, if the taxpayer making the election is not an individual, the statement shall be signed by the person or persons required to sign the income return of such taxpayer.

(3) *Filing.* The statement must be filed on or before December 31, 1954, in the office of the district director for the internal revenue district in which the income tax return for the year of the election is required to be filed. For rules as to when timely mailing will be treated as timely filing of the statement see section 7502.

(4) *Filing of duplicate.* A copy of the statement of election must be filed with the first return, amended return, or claim for refund filed on or after the date on which the election is made.

(c) *Election made on or before December 31, 1952.* An election made on or before December 31, 1952, in accordance with the provisions of section 113(d) of the Internal Revenue Code of 1939, may be revoked by filing on or before December 31, 1954, in the same office in which the election was filed, a statement of revocation signed in the same manner as the election. Such statement made by any person is irrevocable when made with respect to such person, and

no new election may thereafter be made by such person. A copy of the revocation must be filed with the first return, amended return, or claim for refund, filed after the date of the revocation. For additional rules with respect to election made on or before December 31, 1952, see 26 CFR (1939) 39.113(b)(1)–1 (Regulations 118).

(d) *Validity of elections or revocation of elections.* An election or revocation of an election which conforms in substance to the provisions of this section will not be deemed invalid solely because it was filed before the date on which the regulations in this section were promulgated.

(e) *Effect of election.* For rules relating to the effect of an election under this section, see section 1016(a)(2) and the regulations thereunder.

§ 1.1021–1 Sale of annuities.

In the case of a transfer for value of an annuity contract to which section 72(g) and paragraph (a) of § 1.72–10 apply, the transferor shall adjust his basis in such contract as of the time immediately prior to such transfer by subtracting from the premiums or other consideration he has paid or is deemed to have paid for such contract all amounts he has received or is deemed to have received under such annuity contract to the extent that such amounts were not includible in the gross income of the transferor or other recipient under the applicable income tax law. In any case where the amounts which were not includible in the gross income of the recipient were received or deemed to have been received by such transferor exceed the amounts paid or deemed paid by him, the adjusted basis of the contract shall be zero. The income realized by the transferor on such a transfer shall not exceed the total of the amounts received as consideration for the transfer.

COMMON NONTAXABLE EXCHANGES

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[T.D. 8346, 56 FR 19937, May 1, 1991, as amended by T.D. 9935, 85 FR 77378, Dec. 2, 2020]

§ 1.1031(a)–1 Property held for productive use in trade or business or for investment.

(a) *In general*—(1) *Exchanges of property solely for property of a like kind.* Section 1031(a)(1) provides an exception from the general rule requiring the recognition of gain or loss upon the sale or exchange of property. Under section 1031(a)(1), no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment. Under section 1031(a)(1), property held for productive use in a trade or business may be exchanged for property held for investment. Similarly, under section 1031(a)(1), property held for investment may be exchanged for property held for productive use in a trade or business. However, section 1031(a)(2) provides that section 1031(a)(1) does not apply to any exchange of—

(i) Stock in trade or other property held primarily for sale;

(ii) Stocks, bonds, or notes;

(iii) Other securities or evidences of indebtedness or interest;

(iv) Interests in a partnership;

(v) Certificates of trust or beneficial interests; or

(vi) Choses in action.

Section 1031(a)(1) does not apply to any exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships. An interest in a partnership that has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K is treated as an interest in each of the assets of the partnership and not as an interest in a partnership for purposes of section 1031(a)(2)(D) and paragraph (a)(1)(iv) of this section. An exchange of an interest in such a partnership does not qualify for nonrecognition of gain or loss under section 1031 with respect to any asset of the partnership that is described in section 1031(a)(2) or to the extent the exchange of assets of the partnership does not otherwise satisfy the requirements of section 1031(a).

(2) *Exchanges of property not solely for property of a like kind.* A transfer is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or property which does not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). Similarly, a transfer is not within the provisions of section 1031(a) if, as part of the consideration, the other party to the exchange assumes a liability of the taxpayer (or acquires property from the taxpayer that is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). A transfer of property meeting the requirements of section 1031(a) may be within the provisions of section 1031(a) even though the taxpayer transfers in addition property not meeting the requirements of section 1031(a) or money. However, the nonrecognition treatment provided by section 1031(a) does not apply to the property transferred which does not meet the requirements of section 1031(a).

(3) *Exchanges after 2017.* Pursuant to section 13303 of Public Law 115–97 (131 Stat. 2054), for exchanges beginning after December 31, 2017, section 1031 and §§ 1.1031(a)–1, 1.1031(b)–2, 1.1031(d)–1T, 1.1031(d)–2, 1.1031(j)–1, 1.1031(k)–1, and references to section 1031 in §§ 1.1031(b)–1, 1.1031(c)–1, and 1.1031(d)–1, apply only to qualifying exchanges of real property (within the meaning of § 1.1031(a)–3) that is held for productive use in a trade or business, or for investment, and that is not held primarily for sale.

(b) *Definition of "like kind."* As used in section 1031(a), the words *like kind* have reference to the nature or character of the property and not to its grade or quality. One kind or class of

property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale. For additional rules for exchanges of personal property, see § 1.1031 (a)–2.

(c) *Examples of exchanges of property of a ''like kind.''* No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

(d) *Examples of exchanges not solely in kind.* Gain or loss is recognized if, for instance, a taxpayer exchanges (1) Treasury bonds maturing March 15, 1958, for Treasury bonds maturing December 15, 1968, unless section 1037(a) (or so much of section 1031 as relates to section 1037(a)) applies to such exchange, or (2) a real estate mortgage for consolidated farm loan bonds.

(e) *Applicability dates*—(1) *Exchanges of partnership interests.* The provisions of paragraph (a)(1) of this section relating to exchanges of partnership interests apply to transfers of property made by taxpayers on or after April 25, 1991.

(2) *Exchanges after 2017.* The provisions of paragraph (a)(3) of this section apply to exchanges beginning after December 2, 2020.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15822, Nov. 17, 1967; T.D. 8343, 56 FR 14854, Apr. 12, 1991; T.D. 8346, 56 FR 19937, May 1, 1991; T.D. 9935, 85 FR 77378, Dec. 2, 2020]

§ 1.1031(a)–2 Additional rules for exchanges of personal property.

(a) *Introduction.* Section 1.1031(a)–1(b) provides that the nonrecognition rules of section 1031 do not apply to an exchange of one kind or class of property for property of a different kind or class. This section contains additional rules for determining whether personal property has been exchanged for property of a like kind or like class. Personal properties of a like class are considered to be of a ''like kind'' for purposes of section 1031. In addition, an exchange of properties of a like kind may qualify under section 1031 regardless of whether the properties are also of a like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class. Under paragraph (b) of this section, depreciable tangible personal properties are of a like class if they are either within the same General Asset Class (as defined in paragraph (b)(2) of this section) or within the same Product Class (as defined in paragraph (b)(3) of this section). Paragraph (c) of this section provides rules for exchanges of intangible personal property and nondepreciable personal property.

(b) *Depreciable tangible personal property*—(1) *General rule.* Depreciable tangible personal property is exchanged for property of a ''like kind'' under section 1031 if the property is exchanged for property of a like kind or like class. Depreciable tangible personal property is of a like class to other depreciable tangible personal property if the exchanged properties are either within the same General Asset Class or within the same Product Class. A single property may not be classified within more than one General Asset Class or within more than one Product Class. In addition, property classified within any General Asset Class may not be classified within a Product Class. A property's General Asset Class or Product Class is determined as of the date of the exchange.

(2) *General Asset Classes.* Except as provided in paragraphs (b)(4) and (b)(5) of this section, property within a General Asset Class consists of depreciable tangible personal property described in one of asset classes 00.11 through 00.28

and 00.4 of Rev. Proc. 87–56, 1987–2 C.B. 674. These General Asset Classes describe types of depreciable tangible personal property that frequently are used in many businesses. The General Asset Classes are as follows:

(i) Office furniture, fixtures, and equipment (asset class 00.11),

(ii) Information systems (computers and peripheral equipment) (asset class 00.12),

(iii) Data handling equipment, except computers (asset class 00.13),

(iv) Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21),

(v) Automobiles, taxis (asset class 00.22),

(vi) Buses (asset class 00.23),

(vii) Light general purpose trucks (asset class 00.241),

(viii) Heavy general purpose trucks (asset class 00.242),

(ix) Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25),

(x) Tractor units for use over-the-road (asset class 00.26),

(xi) Trailers and trailer-mounted containers (asset class 00.27),

(xii) Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28), and

(xiii) Industrial steam and electric generation and/or distribution systems (asset class 00.4).

(3) *Product classes*. Except as provided in paragraphs (b)(4) and (5) of this section, or as provided by the Commissioner in published guidance of general applicability, property within a product class consists of depreciable tangible personal property that is described in a 6-digit product class within Sectors 31, 32, and 33 (pertaining to manufacturing industries) of the North American Industry Classification System (NAICS), set forth in Executive Office of the President, Office of Management and Budget, *North American Industry Classification System*, United States, 2002 (NAICS Manual), as periodically updated. Copies of the NAICS Manual may be obtained from the National Technical Information Service, an agency of the U.S. Department of Commerce, and may be accessed on the internet. Sectors 31 through 33 of the NAICS Manual contain listings of specialized industries for the manufacture of described products and equipment. For this purpose, any 6-digit NAICS product class with a last digit of 9 (a miscellaneous category) is not a product class for purposes of this section. If a property is listed in more than one product class, the property is treated as listed in any one of those product classes. A property's 6-digit product class is referred to as the property's NAICS code.

(4) *Modifications of NAICS product classes*. The product classes of the NAICS Manual may be updated or otherwise modified from time to time as the manual is updated, effective on or after the date of the modification. The NAICS Manual generally is modified every five years, in years ending in a 2 or 7 (such as 2002, 2007, and 2012). The applicability date of the modified NAICS Manual is announced in the FEDERAL REGISTER and generally is January 1 of the year the NAICS Manual is modified. Taxpayers may rely on these modifications as they become effective in structuring exchanges under this section. Taxpayers may rely on the previous NAICS Manual for transfers of property made by a taxpayer during the one-year period following the effective date of the modification. For transfers of property made by a taxpayer on or after January 1, 1997, and on or before January 1, 2003, the NAICS Manual of 1997 may be used for determining product classes of the exchanged property.

(5) *Administrative procedures for revising general asset classes and product classes*. The Commissioner may, through published guidance of general applicability, supplement, modify, clarify, or update the guidance relating to the classification of properties provided in this paragraph (b). (See § 601.601(d)(2) of this chapter.) For example, the Commissioner may determine not to follow (in whole or in part) a general asset class for purposes of identifying property of like class, may determine not to follow (in whole or in part) any modification of product classes published in the NAICS Manual, or may determine that other properties

not listed within the same or in any product class or general asset class nevertheless are of a like class. The Commissioner also may determine that two items of property that are listed in separate product classes or in product classes with a last digit of 9 are of a like class, or that an item of property that has a NAICS code is of a like class to an item of property that does not have a NAICS code.

(6) *No inference outside of section 1031.* The rules provided in this section concerning the use of general asset classes or product classes are limited to exchanges under section 1031. No inference is intended with respect to the classification of property for other purposes, such as depreciation.

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

Example 1. Taxpayer A transfers a personal computer (asset class 00.12) to B in exchange for a printer (asset class 00.12). With respect to A, the properties exchanged are within the same General Asset Class and therefore are of a like class.

Example 2. Taxpayer C transfers an airplane (asset class 00.21) to D in exchange for a heavy general purpose truck (asset class 00.242). The properties exchanged are not of a like class because they are within different General Asset Classes. Because each of the properties is within a General Asset Class, the properties may not be classified within a Product Class. The airplane and heavy general purpose truck are also not of a like kind. Therefore, the exchange does not qualify for nonrecognition of gain or loss under section 1031.

Example 3. Taxpayer E transfers a grader to F in exchange for a scraper. Neither property is within any of the general asset classes. However, both properties are within the same product class (NAICS code 333120). The grader and scraper are of a like class and deemed to be of a like kind for purposes of section 1031.

Example 4. Taxpayer G transfers a personal computer (asset class 00.12), an airplane (asset class 00.21) and a sanding machine (NAICS code 333210), to H in exchange for a printer (asset class 00.12), a heavy general purpose truck (asset class 00.242) and a lathe (NAICS code 333210). The personal computer and the printer are of a like class because they are within the same general asset class. The sanding machine and the lathe are of a like class because they are within the same product class (although neither property is within any of the general asset classes). The airplane and the heavy general purpose truck are neither within the same general asset class nor within the same product class, and are not of a like kind.

(8) *Transition rule.* Properties within the same product classes based on the 4-digit codes contained in Division D of the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (1987), will be treated as property of a like class for transfers of property made by taxpayers on or before May 19, 2005.

(c) *Intangible personal property and nondepreciable personal property*—(1) *General rule.* An exchange of intangible personal property of nondepreciable personal property qualifies for nonrecognition of gain or loss under section 1031 only if the exchanged properties are of a like kind. No like classes are provided for these properties. Whether intangible personal property is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved (e.g., a patent or a copyright) and also on the nature or character of the underlying property to which the intangible personal property relates.

(2) *Goodwill and going concern value.* The goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business.

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

Example 1. Taxpayer K exchanges a copyright on a novel for a copyright on a different novel. The properties exchanged are of a like kind.

Example 2. Taxpayer J exchanges a copyright on a novel for a copyright on a song. The properties exchanged are not of a like kind.

(d) *Effective date.* Except as otherwise provided in this paragraph (d), this section applies to exchanges occurring on or after April 11, 1991. Paragraphs (b)(3) through (b)(6), *Example 3* and *Example 4* of paragraph (b)(7), and paragraph (b)(8) of this section apply to transfers of property made by taxpayers on or after August 12, 2004. However, taxpayers may apply paragraphs (b)(3) through (b)(6), and *Example 3* and *Example 4* of paragraph (b)(7) of this section to

transfers of property made by taxpayers on or after January 1, 1997, in taxable years for which the period of limitation for filing a claim for refund or credit under section 6511 has not expired.

[T.D. 8343, 56 FR 14854, Apr. 12, 1991, as amended by T.D. 9151, 69 FR 50068, Aug. 13, 2004; T.D. 9202, 70 FR 28819, May 19, 2005]

§ 1.1031(a)–3 Definition of real property.

(a) *Real property*—(1) *In general.* The term *real property* under section 1031 and §§ 1.1031(a)–1 through 1.1031(k)–1 means land and improvements to land, unsevered natural products of land, and water and air space superjacent to land. Under paragraph (a)(5) of this section, an intangible interest in real property of a type described in this paragraph (a)(1) is real property for purposes of section 1031 and this section. Property that is real property under State or local law as provided in paragraph (a)(6) of this section is real property for purposes of section 1031 and this section.

(2) *Improvements to land*—(i) *In general.* The term *improvements to land* means inherently permanent structures and the structural components of inherently permanent structures.

(ii) *Inherently permanent structures*—(A) *In general.* The term *inherently permanent structure* means any building or other structure that is a distinct asset within the meaning of paragraph (a)(4) of this section and is permanently affixed to real property and that will ordinarily remain affixed for an indefinite period of time. Affixation is considered permanent if it is reasonably expected to last indefinitely based on all the facts and circumstances.

(B) *Building.* A building is any structure or edifice enclosing a space within its walls, and 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. Buildings include the following distinct assets if permanently affixed: Houses, apartments, hotels, motels, enclosed stadiums and arenas, enclosed shopping malls, factories and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores.

(C) *Other inherently permanent structures.* Inherently permanent structures under paragraph (a)(2)(ii) of this section include the following distinct assets, if permanently affixed: In-ground swimming pools; roads; bridges; tunnels; paved parking areas, parking facilities, and other pavements; special foundations; stationary wharves and docks; fences; inherently permanent advertising displays for which an election under section 1033(g)(3) is in effect; inherently permanent outdoor lighting facilities; railroad tracks and signals; telephone poles; power generation and transmission facilities; permanently installed telecommunications cables; microwave transmission, cell, broadcasting, and electric transmission towers; oil and gas pipelines; offshore platforms, derricks, oil and gas storage tanks; and grain storage bins and silos. Affixation to real property may be accomplished by weight alone. If property is not listed as an inherently permanent structure in paragraph (a)(2)(ii)(B) or (C) of this section, the determination of whether the property is an inherently permanent structure under paragraph (a)(2)(ii) of this section is based on the following factors—

(*1*) The manner in which the distinct asset is affixed to real property;

(*2*) Whether the distinct asset is designed to be removed or to remain in place;

(*3*) The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed;

(*4*) Any circumstances that suggest the expected period of affixation is not indefinite; and

(*5*) The time and expense required to move the distinct asset.

(iii) *Structural components*—(A) *In general.* The term *structural component* means any distinct asset, within the meaning of paragraph (a)(4) of this section, that is a constituent part of, and integrated into, an inherently permanent structure. If interconnected assets work together to serve an inherently permanent structure (for example, systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset

that may be a structural component. A structural component may qualify as real property only if the taxpayer holds its interest in the structural component together with a real property interest in the space in the inherently permanent structure served by the structural component. If a distinct asset is customized, the customization does not affect whether the distinct asset is a structural component. Tenant improvements to a building that are inherently permanent or otherwise classified as real property within the meaning of this paragraph (a)(2)(iii) are real property under this section. However, property produced for sale, such as bricks, nails, paint, and windowpanes, that is not real property in the hands of the producing taxpayer or a related person, as defined in section 1031(f)(3), but that may be incorporated into real property by an unrelated buyer, is not treated as real property by the producing taxpayer.

(B) *Examples of structural components.* Structural components include the following items, provided the item is a constituent part of, and integrated into, an inherently permanent structure: Walls; partitions; doors; wiring; plumbing systems; central air conditioning and heating systems; pipes and ducts; elevators and escalators; floors; ceilings; permanent coverings of walls, floors, and ceilings; insulation; chimneys; fire suppression systems, including sprinkler systems and fire alarms; fire escapes; security systems; humidity control systems; and other similar property. If a component of a building or inherently permanent structure is a distinct asset and is not listed as a structural component in this paragraph (a)(2)(iii)(B), the determination of whether the component is a structural component under this paragraph (a)(2)(iii) is based on the following factors—

(*1*) The manner, time, and expense of installing and removing the component;

(*2*) Whether the component is designed to be moved;

(*3*) The damage that removal of the component would cause to the item itself or to the inherently permanent structure to which it is affixed; and

(*4*) Whether the component is installed during construction of the inherently permanent structure.

(3) *Unsevered natural products of land.* Unsevered natural products of land, including growing crops, plants, and timber; mines; wells; and other natural deposits, generally are treated as real property for purposes of this section. Natural products and deposits, such as crops, timber, water, ores, and minerals, cease to be real property when they are severed, extracted, or removed from the land.

(4) *Distinct asset*—(i) *In general.* For this section, a distinct asset is analyzed separately from any other assets to which the asset relates to determine if the asset is real property, whether as land, an inherently permanent structure, or a structural component of an inherently permanent structure. Buildings and other inherently permanent structures are distinct assets. Assets and systems listed as a structural component in paragraph (a)(2)(iii)(B) of this section are treated as distinct assets.

(ii) *Facts and circumstances.* The determination of whether a particular separately identifiable item of property is a distinct asset is based on all the facts and circumstances. In particular, the following factors must be taken into account—

(A) Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;

(B) Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset;

(C) Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and

(D) Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.

(5) *Intangible assets*—(i) *In general.* Intangible assets that are real property for purposes of section 1031 and this section include the following items: Fee ownership; co-ownership; a leasehold; an option to acquire real property; an easement; stock in a cooperative housing corporation; shares in a

mutual ditch, reservoir, or irrigation company described in section 501(c)(12)(A) of the Code if, at the time of the exchange, such shares have been recognized by the highest court of the State in which the company was organized, or by a State statute, as constituting or representing real property or an interest in real property; and land development rights. Similar interests are real property for purposes of section 1031 and this section if the intangible asset derives its value from real property or an interest in real property and is inseparable from that real property or interest in real property. The following intangible assets are not real property for purposes of section 1031 and this section, regardless of the classification of such property under State or local law—

(A) Stock not described in paragraph (a)(5)(i) of this section, bonds, or notes;

(B) Other securities or evidences of indebtedness or interest;

(C) Interests in a partnership (other than an interest in a partnership that has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K);

(D) Certificates of trust or beneficial interests; and

(E) Choses in action.

(ii) *Licenses and permits.* A license, permit, or other similar right that is solely for the use, enjoyment, or occupation of land or an inherently permanent structure and that is in the nature of a leasehold, easement, or other similar right, generally is an interest in real property under this section. However, a license or permit to engage in or operate a business on real property is not real property or an interest in real property, regardless of its classification under State or local law.

(6) *State or local law.* Except as otherwise provided in paragraph (a)(5) of this section, property is real property within the meaning of paragraph (a)(1) of this section under State or local law if, on the date it is transferred in an exchange, the property is real property under the law of the State or local jurisdiction in which that property is located.

(7) *No inference outside of section 1031.* The rules provided in this section concerning the definition of real property apply only for purposes of section 1031. No inference is intended with respect to the classification or characterization of property for other purposes of the Code, such as depreciation and sections 1245 and 1250. For example, a structure or a portion of a structure may be section 1245 property for depreciation purposes and for determining gain under section 1245, notwithstanding that the structure or the portion of the structure is real property under this section. Also, a taxpayer transferring relinquished property that is section 1245 property in a section 1031 exchange is subject to the gain recognition rules under section 1245 and the regulations under section 1245, notwithstanding that the relinquished property or replacement property is real property under this section. In addition, the taxpayer must follow the rules of section 1245 and the regulations under section 1245, and section 1250 and the regulations under section 1250, based on the determination of the relinquished property and replacement property being, in whole or in part, section 1245 property or section 1250 property under those Code sections and not under this section.

(b) *Examples.* The following examples illustrate the provisions of this section. In each example, unless otherwise provided, the State or local law of the applicable jurisdiction in which the property at issue is located does not address whether the property is real property.

(1) *Example 1: Natural products of land.* A owns land with perennial fruit-bearing plants that A harvests annually. The unsevered plants are natural products of the land within the meaning of paragraph (a)(3) of this section and thus are real property for purposes of section 1031. A annually harvests fruit from the plants. Upon severance from the land, the harvested fruit ceases to be part of the land and therefore is not real property. Storage of the harvested fruit upon or within real property does not cause the harvested fruit to be real property.

(2) *Example 2: Water space superjacent to land.* B owns a marina comprised of U-shaped boat slips and end ties. The U-shaped boat slips are spaces on the water that are surrounded by a dock on

three sides. The end ties are spaces on the water at the end of a slip or on a long, straight dock. B rents the boat slips and end ties to boat owners. The boat slips and end ties are water space superjacent to land and thus are real property within the meaning of paragraph (a)(1) of this section.

(3) *Example 3: Indoor sculpture.* (i) C owns an office building and a large sculpture in the atrium of the building. The sculpture measures 30 feet tall by 18 feet wide and weighs five tons. The building was specifically designed to support the sculpture, which is permanently affixed to the building by supports embedded in the building's foundation. The sculpture was constructed within the building. Removal would be costly and time consuming and would destroy the sculpture. The sculpture is reasonably expected to remain in the building indefinitely.

(ii) The sculpture is not an inherently permanent structure listed in paragraph (a)(2)(ii)(C) of this section, and, therefore, C must use the factors provided in paragraphs (a)(2)(ii)(C)(*1*) through (*5*) of this section to determine whether the sculpture is an inherently permanent structure. The sculpture—

(A) Is permanently affixed to the building by supports embedded in the building's foundation;

(B) Is not designed to be removed and is designed to remain in place indefinitely;

(C) Would be damaged if removed and would damage the building to which it is affixed;

(D) Is expected to remain in the building indefinitely; and

(E) Would require significant time and expense to move.

(iii) The factors described in paragraphs (a)(2)(ii)(C)(*1*) through (*5*) of this section all support the conclusion that the sculpture is an inherently permanent structure within the meaning of paragraph (a)(2)(ii)(A) of this section. Therefore, the sculpture is real property.

(4) *Example 4: Bus shelters.* (i) D owns 400 bus shelters, each of which consists of four posts, a roof, and panels enclosing two or three sides. D enters into a long-term lease with a local transit authority for use of the bus shelters. Each bus shelter is prefabricated from steel and is bolted to the sidewalk. Bus shelters are disassembled and moved when bus routes change. Moving a bus shelter takes less than a day and does not significantly damage either the bus shelter or the real property to which it was affixed.

(ii) The bus shelters are not permanently affixed enclosed transportation stations or terminals, are not buildings under paragraph (a)(2)(ii)(B) of this section, nor are they listed as types of other inherently permanent structures in paragraph (a)(2)(ii)(C) of this section. Therefore, the bus shelters must be analyzed to determine whether they are inherently permanent structures using the factors provided in paragraphs (a)(2)(ii)(C)(*1*) through (*5*) of this section. The bus shelters—

(A) Are not permanently affixed to the land or an inherently permanent structure;

(B) Are designed to be removed and not remain in place indefinitely;

(C) Would not be damaged if removed and would not damage the sidewalks to which they are affixed;

(D) Will not remain affixed indefinitely; and

(E) Would not require significant time and expense to move.

(iii) The factors described in paragraphs (a)(2)(ii)(C)(*1*) through (*5*) of this section all support the conclusion that the bus shelters are not inherently permanent structures within the meaning of paragraph (a)(2)(ii) of this section. Thus, the bus shelters are not inherently permanent structures within the meaning of paragraph (a)(2)(ii) of this section and, therefore, are not real property.

(5) *Example 5: Industrial 3D printer and generator.* (i) E owns a building that it uses in its trade or business of manufacturing airplane parts. The building includes an industrial 3D printer that can print airplane wings and an electrical generator that serves the building and the 3D printer in a backup capacity. The 3D printer weighs 12 tons, is designed to remain in place indefinitely once installed in the building, and its removal would be time-consuming and very costly, and would cause significant damage to the building. The 3D printer was installed during the building's construction. The

generator also was installed during construction and is designed to remain in place indefinitely once installed. Although costly and time-consuming to remove, removal of the generator will not result in substantial damage to the generator or the building.

(ii) The 3D printer is not listed as an example of a structural component under paragraph (a)(2)(iii)(B) of this section. Therefore, the 3D printer must be analyzed to determine whether it is a structural component using the factors provided in paragraphs (a)(2)(iii)(B)(*1*) through (*4*) of this section. The 3D printer—

(A) Is time-consuming and costly to move;

(B) Is not designed to be moved;

(C) If removed, would cause significant damage to the building in which it is located; and

(D) Was installed during construction of the building.

(iii) The factors described in paragraphs (a)(2)(iii)(B)(*1*) through (*4*) of this section support the conclusion that the 3D printer is a structural component of E's building and real property under this section. Thus, the 3D printer is real property.

(iv) The electrical generator also is not listed as an example of a structural component under paragraph (a)(2)(iii)(B) of this section and must be analyzed to determine whether it is a structural component using the factors provided in paragraphs (a)(2)(iii)(B)(*1*) through (*4*) of this section. The generator—

(A) Is time-consuming and costly to move;

(B) Is not designed to be moved;

(C) If removed, would not result in significant damage to the generator or the building in which it is located; and

(D) Was installed during construction of the building.

(v) The factors described in paragraphs (a)(2)(iii)(B)(*1*) through (*4*) of this section, considered in the aggregate, support the conclusion that the generator is a structural component of E's building. Although the generator's removal would not result in significant damage to the generator or to E's building, that factor does not outweigh the factors supporting the conclusion that it is a structural component. Consequently, the generator is a structural component of E's building and real property under this section.

(6) *Example 6: Raised flooring for industrial 3D printer.* (i) The facts are the same as in paragraph (b)(5), *Example 5*, except that E, when installing its 3D printer, also installed a raised flooring system for the purpose of facilitating the operation of the 3D printer. The raised flooring system is not designed or constructed to remain permanently in place. Rather, the raised flooring system can be removed, without any substantial damage to the system itself or to the building, and then reused. The raised flooring was installed during the building's construction.

(ii) Although floors are listed as an example of a structural component under paragraph (a)(2)(iii)(B) of this section, the raised flooring system installed to facilitate the operation of E's 3D printer is not a constituent part of, and integrated into, an inherently permanent structure as required by paragraph (a)(2)(iii)(A) of this section and, therefore, is not flooring as listed in paragraph (a)(2)(iii)(B) of this section. Thus, the raised flooring must be analyzed to determine whether it is a structural component of E's building (within the meaning of paragraph (a)(2)(iii) of this section) using the factors provided in paragraphs (a)(2)(iii)(B)(*1*) through (*4*) of this section. The raised flooring—

(A) Is installed and removed quickly and with little expense;

(B) Is designed to be moved and is not designed specifically for the particular building of which it is a part;

(C) Is not damaged, and the building is not damaged, upon its removal; and

(D) Was installed during construction of the building.

(iii) The factors described in paragraphs (a)(2)(iii)(B)(*1*) through (*4*) of this section, considered in the aggregate, support the conclusion that the raised flooring is not a structural component of E's building within the meaning of paragraph (a)(2)(iii) of this section. Although the raised flooring was installed during construction of

the building, that factor does not outweigh the factors supporting the conclusion that the flooring is not a structural component. Therefore, the raised flooring is not real property.

(7) *Example 7: Steam turbine.* (i) F owns a building with a large steam turbine attached as a fixture to the building. The steam turbine is a component of a system used for the commercial production of electricity for sale to customers in the ordinary course of F's business as an electric utility. The steam turbine also generates electricity for F's building. The steam turbine takes up a substantial portion of the building and is designed to remain in place indefinitely once installed in F's building. The steam turbine was installed during the construction of the building and its removal would be costly and cause damage to the building.

(ii) The steam turbine is not listed as an example of a structural component under paragraph (a)(2)(iii)(B) of this section and must be analyzed to determine whether it is a structural component using the factors provided in paragraphs (a)(2)(iii)(B)(*1*) through (*4*) of this section. The steam turbine—

(A) Is costly to remove from the building in which it is located;

(B) Is not designed to be moved;

(C) If removed, would cause damage to the building; and

(D) Was installed during construction of the building.

(iii) The factors described in paragraphs (a)(2)(iii)(B)(*1*) through (*4*) of this section support the conclusion that the steam turbine is a structural component of F's building and real property under this section. Thus, the steam turbine is real property.

(8) *Example 8: Partitions.* (i) G owns an office building that it leases to tenants. The building includes partitions owned by G that are used to delineate space within the building. The office building has two types of interior, non-load-bearing drywall partition systems: A conventional drywall partition system (Conventional Partition System) and a modular drywall partition system (Modular Partition System). Neither the Conventional Partition System nor the Modular Partition System was installed during construction of the office building. Conventional Partition Systems are comprised of fully integrated gypsum board partitions, studs, joint tape, and covering joint compound. Modular Partition Systems are comprised of assembled panels, studs, tracks, and exposed joints. Both the Conventional Partition System and the Modular Partition System reach from the floor to the ceiling. In addition, both are distinct assets as described in paragraph (a)(4) of this section.

(ii) Depending on the needs of a new tenant, the Conventional Partition System may remain in place when a tenant vacates the premises. The Conventional Partition System is integrated into the office building and is designed and constructed to remain in areas not subject to reconfiguration or expansion. The Conventional Partition System can be removed only by demolition, and, once removed, neither the Conventional Partition System nor its components can be reused. Removal of the Conventional Partition System causes substantial damage to the Conventional Partition System itself, but does not cause substantial damage to the building.

(iii) Modular Partition Systems are typically removed when a tenant vacates the premises. Modular Partition Systems are not designed or constructed to remain permanently in place. Modular Partition Systems are designed and constructed to be movable. Each Modular Partition System can be readily removed, remains in substantially the same condition as before, and can be reused. Removal of a Modular Partition System does not cause any substantial damage to the Modular Partition System itself or to the building. The Modular Partition System may be moved to accommodate the reconfigurations of the interior space within the office building for various tenants that occupy the building.

(iv) The Conventional Partition System is comprised of walls that are integrated into an inherently permanent structure and are listed as structural components in paragraph (a)(2)(iii)(B) of this section. Thus, the Conventional Partition System is real property.

(v) The Modular Partition System is not integrated into the building as required by paragraph (a)(2)(iii)(A) of

this section and, therefore, is not listed in paragraph (a)(2)(iii)(B) of this section. Thus, the Modular Partition System must be analyzed to determine whether it is a structural component using the factors provided in paragraphs (a)(2)(iii)(B)(*1*) through (*4*) of this section. The Modular Partition System—

(A) Is installed and removed quickly and with little expense;

(B) Is designed to be moved and is not designed specifically for the particular building of which it is a part;

(C) Is not damaged, and the building is not damaged, upon its removal; and

(D) Was not installed during construction of the building.

(vi) The factors described in paragraphs (a)(2)(iii)(B)(*1*) through (*4*) of this section support the conclusion that the Modular Partition System is not a structural component of G's office building within the meaning of paragraph (a)(2)(iii) of this section. Therefore, the Modular Partition System is not real property.

(9) *Example 9: Pipeline transmission system.* (i) H owns a natural gas pipeline transmission system that provides a conduit to transport natural gas from unrelated third-party producers and gathering facilities to unrelated third-party distributors and end users. The pipeline transmission system is comprised of underground pipelines, isolation valves and vents, pressure control and relief valves, meters, and compressors. Each of these distinct assets was installed during construction of the pipeline transmission system and each was designed to remain permanently in place.

(ii) The pipelines are permanently affixed and are listed as other inherently permanent structures in paragraph (a)(2)(ii)(C) of this section. Thus, the pipelines are real property.

(iii) Isolation valves and vents are placed at regular intervals along the pipelines to isolate and evacuate sections of the pipelines in case there is need for a shut-down or maintenance of the pipelines. Pressure control and relief valves are installed at regular intervals along the pipelines to provide overpressure protection. The isolation valves and vents and pressure control and relief valves are not listed in paragraph (a)(2)(iii)(B) of this section and, therefore, must be analyzed to determine whether they are structural components using the factors provided in paragraphs (a)(2)(iii)(B)(*1*) through (*4*) of this section. The isolation valves and vents and pressure control and relief valves—

(A) Are time consuming and expensive to install and remove from the pipelines;

(B) Are designed specifically for the particular pipelines for which they are a part;

(C) Will sustain damage and will damage the pipelines if removed; and

(D) Were installed during construction of the pipelines.

(iv) The factors in paragraphs (a)(2)(iii)(B)(*1*) through (*4*) of this section support the conclusion that the isolation valves and vents and pressure control and relief valves are structural components of H's pipelines within the meaning of paragraph (a)(2)(iii) of this section. Therefore, the isolation valves and vents and pressure control and relief valves are real property.

(v) Meters are used to measure the natural gas passing into or out of the pipeline transmission system for purposes of determining the end users' consumption. Over long distances, pressure is lost due to friction in the pipeline transmission system. Compressors are required to add pressure to transport natural gas through the entirety of the pipeline transmission system. H installed meters and compressors during the construction of the pipelines. However, unlike other types of such meters and compressors, these particular meters and compressors are not time consuming and expensive to install and remove from the pipelines; are not designed specifically for the particular pipelines for which they are a part; and their removal does not cause damage to the asset or the pipelines if removed. Therefore, the meters and compressors installed by H are not structural components within the meaning of paragraph (a)(2)(iii) of this section and, therefore, are not real property.

(10) *Example 10: State or local law determination of property.* (i) J owns water pipeline in State X that it wants to exchange for cell phone towers located in

State Y. On the date that J transfers the water pipeline in an exchange for the cell phone towers, the water pipeline is classified as real property under the law of State X, the jurisdiction in which the water pipeline is located.

(ii) The water pipeline is real property under paragraphs (a)(1) and (a)(6) of this section, regardless of whether the water pipeline is listed as an inherently permanent structure or a structural component of an inherently permanent structure, or is real property under the factors listed in paragraph (a)(2)(ii)(C) or (a)(2)(iii)(B) of this section.

(iii) Cell phone towers are listed as an inherently permanent structure under paragraph (a)(2)(ii)(C) of this section. Thus, the cell phone towers that J acquires in the exchange for the water pipeline are real property under this section, regardless of the State or local characterization of the cell phone towers or whether the cell phone towers are real property under the factors in paragraph (a)(2)(ii)(C) or (a)(2)(iii)(B) of this section.

(11) *Example 11: Land use permit.* K receives a special use permit from the government to place a cell tower on Federal Government land that abuts a Federal highway. Government regulations provide that the permit is not a lease of the land, but is a permit to use the land for a cell tower. Under the permit, the government reserves the right to cancel the permit and compensate K if the site is needed for a higher public purpose. The permit is in the nature of a leasehold that allows K to place a cell tower in a specific location on government land. Therefore, the permit is an interest in real property under paragraph (a)(5) of this section.

(12) *Example 12: License to operate a business.* L owns a building and receives a license from State A to operate a casino in the building. The license applies only to K's building and cannot be transferred to another location. L's building is an inherently permanent structure under paragraph (a)(2)(ii)(A) of this section and, therefore, is real property. However, L's license to operate a casino is not a right for the use, enjoyment, or occupation of L's building, but is rather a license to engage in or operate the casino business in the building. Therefore, the casino license is not real property or an interest in real property under paragraph (a)(5)(ii) of this section.

(c) *Applicability date.* This section applies to exchanges beginning after December 2, 2020.

[T.D. 9935, 85 FR 77378, Dec. 2, 2020]

§ 1.1031(b)–1 Receipt of other property or money in tax-free exchange.

(a) If the taxpayer receives other property (in addition to property permitted to be received without recognition of gain) or money—

(1) In an exchange described in section 1031(a) of property held for investment or productive use in trade or business for property of like kind to be held either for productive use or for investment,

(2) In an exchange described in section 1035(a) of insurance policies or annuity contracts,

(3) In an exchange described in section 1036(a) of common stock for common stock, or preferred stock for preferred stock, in the same corporation and not in connection with a corporate reorganization, or

(4) In an exchange described in section 1037(a) of obligations of the United States, issued under the Second Liberty Bond Act (31 U.S.C. 774 (2)), solely for other obligations issued under such Act, the gain, if any, to the taxpayer will be recognized under section 1031(b) in an amount not in excess of the sum of the money and the fair market value of the other property, but the loss, if any, to the taxpayer from such an exchange will not be recognized under section 1031(c) to any extent.

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

Example 1. A, who is not a dealer in real estate, in 1954 exchanges real estate held for investment, which he purchased in 1940 for $5,000, for other real estate (to be held for productive use in trade or business) which has a fair market value of $6,000, and $2,000 in cash. The gain from the transaction is $3,000, but is recognized only to the extent of the cash received of $2,000.

Example 2. (a) B, who uses the cash receipts and disbursements method of accounting and the calendar year as his taxable year, has never elected under section 454(a) to include

in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In 1943, for $750 each, B purchased four $1,000 series E U.S. savings bonds bearing an issue date of March 1, 1943.

(b) On October 1, 1963, the redemption value of each such bond was $1,396, and the total redemption value of the four bonds was $5,584. On that date B submitted the four $1,000 series E bonds to the United States in a transaction in which one of such $1,000 bonds was reissued by issuing four $100 series E U.S. savings bonds bearing an issue date of March 1, 1943, and by considering six $100 series E bonds bearing an issue date of March 1, 1943, to have been issued. The redemption value of each such $100 series E bond was $139.60 on October 1, 1963. Then, as part of the transaction, the six $100 series E bonds so considered to have been issued and the three $1,000 series E bonds were exchanged, in an exchange qualifying under section 1037(a), for five $1,000 series H U.S. savings bonds plus $25.60 in cash.

(c) The gain realized on the exchange qualifying under section 1037(a) is $2,325.60, determined as follows:

Amount realized:		
Par value of five series H bonds		$5,000.00
Cash received		25.60
Total realized		5,025.60
Less: Adjusted basis of series E bonds surrendered in the exchange:		
Three $1,000 series E bonds	$2,250.00	
Six $100 series E bonds at $75 each	450.00	
		2,700.00
Gain realized		2,325.60

(d) Pursuant to section 1031(b), only $25.60 (the money received) of the total gain of $2,325.60 realized on the exchange is recognized at the time of exchange and must be included in B's gross income for 1963. The $2,300 balance of the gain ($2,325.60 less $25.60) must be included in B's gross income for the taxable year in which the series H bonds are redeemed or disposed of, or reach final maturity, whichever is earlier, as provided in paragraph (c) of § 1.454–1.

(e) The gain on the four $100 series E bonds, determined by using $75 as a basis for each such bond, must be included in B's gross income for the taxable year in which such bonds are redeemed or disposed of, or reach final maturity, whichever is earlier.

Example 3. (a) The facts are the same as in example (2), except that, as part of the transaction, the $1,000 series E bond is reissued by considering ten $100 series E bonds bearing an issue date of March 1, 1943, to have been issued. Six of the $100 series E bonds so considered to have been issued are surrendered to the United States as part of the exchange qualifying under section 1037(a) and the other four are immediately redeemed.

(b) Pursuant to section 1031(b), only $25.60 (the money received) of the total gain of $2,325.60 realized on the exchange qualifying under section 1037(a) is recognized at the time of the exchange and must be included in B's gross income for 1963. The $2,300 balance of the gain ($2,325.60 less $25.60) realized on such exchange must be included in B's gross income for the taxable year in which the series H bonds are redeemed or disposed of, or reach final maturity, whichever is earlier, as provided in paragraph (c) of § 1.454–1.

(c) The redemption on October 1, 1963, of the four $100 series E bonds considered to have been issued at such time results in gain of $258.40, which is then recognized and must be included in B's gross income for 1963. This gain of $258.40 is the difference between the $558.40 redemption value of such bonds on the date of the exchange and the $300 (4 × $75) paid for such series E bonds in 1943.

Example 4. On November 1, 1963, C purchased for $91 a marketable U.S. bond which was originally issued at its par value of $100 under the Second Liberty Bond Act. On February 1, 1964, in an exchange qualifying under section 1037(a), C surrendered the bond to the United States for another marketable U.S. bond, which then had a fair market value of $92, and $1.85 in cash, $0.85 of which was interest. The $0.85 interest received is includible in gross income for the taxable year of the exchange, but the $2 gain ($93 less $91) realized on the exchange is recognized for such year under section 1031(b) to the extent of $1 (the money received). Under section 1031(d), C's basis in the bond received in exchange is $91 (his basis of $91 in the bond surrendered, reduced by the $1 money received and increased by the $1 gain recognized).

(c) Consideration received in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as *other property or money* for the purposes of section 1031(b). Where, on an exchange described in section 1031(b), each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of *other property or money* for purposes of section 1031(b), consideration given in the form of an assumption of liabilities (or a receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities

(or a transfer subject to a liability). See § 1.1031(d)–2, examples (1) and (2).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15822, Nov. 17, 1967]

§ 1.1031(b)–2 Safe harbor for qualified intermediaries.

(a) In the case of simultaneous transfers of like-kind properties involving a qualified intermediary (as defined in § 1.1031(k)–1(g)(4)(iii)), the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the transfer and receipt of property by the taxpayer is treated as an exchange.

(b) In the case of simultaneous exchanges of like-kind properties involving a qualified intermediary (as defined in § 1.1031(k)–1(g)(4)(iii)), the receipt by the taxpayer of an evidence of indebtedness of the transferee of the qualified intermediary is treated as the receipt of an evidence of indebtedness of the person acquiring property from the taxpayer for purposes of section 453 and § 15a.453–1(b)(3)(i) of this chapter.

(c) Paragraph (a) of this section applies to transfers of property made by taxpayers on or after June 10, 1991.

(d) Paragraph (b) of this section applies to transfers of property made by taxpayers on or after April 20, 1994. A taxpayer may choose to apply paragraph (b) of this section to transfers of property made on or after June 10, 1991.

[T.D. 8346, 56 FR 19937, May 1, 1991, as amended by T.D. 8535, 59 FR 18749, Apr. 20, 1994]

§ 1.1031(c)–1 Nonrecognition of loss.

Section 1031(c) provides that a loss shall not be recognized from an exchange of property described in section 1031(a), 1035(a), 1036(a), or 1037(a) where there is received in the exchange other property or money in addition to property permitted to be received without recognition of gain or loss. See example (4) of paragraph (a)(3) of § 1.1037–1 for an illustration of the application of this section in the case of an exchange of U.S. obligations described in section 1037(a).

[T.D. 6935, 32 FR 15822, Nov. 17, 1967]

§ 1.1031(d)–1 Property acquired upon a tax-free exchange.

(a) If, in an exchange of property solely of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), no part of the gain or loss was recognized under the law applicable to the year in which the exchange was made, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange. If additional consideration is given by the taxpayer in the exchange, the basis of the property acquired shall be the same as the property transferred increased by the amount of additional consideration given (see section 1016 and the regulations thereunder).

(b) If, in an exchange of properties of the type indicated in section 1031, section 1035(a), section 1036(a), or section 1037(a), gain to the taxpayer was recognized under the provisions of section 1031(b) or a similar provision of a prior revenue law, on account of the receipt of money in the transaction, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized on the exchange. The application of this paragraph may be illustrated by the following example:

Example: A, an individual in the moving and storage business, in 1954 transfers one of his moving trucks with an adjusted basis in his hands of $2,500 to B in exchange for a truck (to be used in A's business) with a fair market value of $2,400 and $200 in cash. A realizes a gain of $100 upon the exchange, all of which is recognized under section 1031(b). The basis of the truck acquired by A is determined as follows:

Adjusted basis of A's former truck	$2,500
Less: Amount of money received	200
Difference	2,300
Plus: Amount of gain recognized	100
Basis of truck acquired by A	2,400

(c) If, upon an exchange of properties of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), the taxpayer received other property (not permitted to be received without the recognition of gain)

and gain from the transaction was recognized as required under section 1031(b), or a similar provision of a prior revenue law, the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of any money received and increased by the amount of gain recognized, must be allocated to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of the basis of the properties received, there must be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. The application of this paragraph may be illustrated by the following example:

Example: A, who is not a dealer in real estate, in 1954 transfers real estate held for investment which he purchased in 1940 for $10,000 in exchange for other real estate (to be held for investment) which has a fair market value of $9,000, an automobile which has a fair market value of $2,000, and $1,500 in cash. A realizes a gain of $2,500, all of which is recognized under section 1031(b). The basis of the property received in exchange is the basis of the real estate A transfers ($10,000) decreased by the amount of money received ($1,500) and increased in the amount of gain that was recognized ($2,500), which results in a basis for the property received of $11,000. This basis of $11,000 is allocated between the automobile and the real estate received by A, the basis of the automobile being its fair market value at the date of the exchange, $2,000, and the basis of the real estate received being the remainder, $9,000.

(d) Section 1031(c) and, with respect to section 1031 and section 1036(a), similar provisions of prior revenue laws provide that no loss may be recognized on an exchange of properties of a type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), although the taxpayer receives other property or money from the transaction. However, the basis of the property or properties (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be allocated to the properties received, and for this purpose there must be allocated to such other property an amount of such basis equivalent to its fair market value at the date of the exchange.

(e) If, upon an exchange of properties of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), the taxpayer also exchanged other property (not permitted to be transferred without the recognition of gain or loss) and gain or loss from the transaction is recognized under section 1002 or a similar provision of a prior revenue law, the basis of the property acquired is the total basis of the properties transferred (adjusted to the date of the exchange) increased by the amount of gain and decreased by the amount of loss recognized on the other property. For purposes of this rule, the taxpayer is deemed to have received in exchange for such other property an amount equal to its fair market value on the date of the exchange. The application of this paragraph may be illustrated by the following example:

Example: A exchanges real estate held for investment plus stock for real estate to be held for investment. The real estate transferred has an adjusted basis of $10,000 and a fair market value of $11,000. The stock transferred has an adjusted basis of $4,000 and a fair market value of $2,000. The real estate acquired has a fair market value of $13,000. A is deemed to have received a $2,000 portion of the acquired real estate in exchange for the stock, since $2,000 is the fair market value of the stock at the time of the exchange. A $2,000 loss is recognized under section 1002 on the exchange of the stock for real estate. No gain or loss is recognized on the exchange of the real estate since the property received is of the type permitted to be received without recognition of gain or loss. The basis of the real estate acquired by A is determined as follows:

Adjusted basis of real estate transferred	$10,000
Adjusted basis of stock transferred	4,000
	14,000
Less: Loss recognized on transfer of stock	2,000
Basis of real estate acquired upon the exchange	12,000

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15823, Nov. 17, 1967]

§ 1.1031(d)–1T Coordination of section 1060 with section 1031 (temporary).

If the properties exchanged under section 1031 are part of a group of assets which constitute a trade or business under section 1060, the like-kind property and other property or money which are treated as transferred in exchange for the like-kind property shall be excluded from the allocation rules of section 1060. However, section 1060 shall apply to property which is not like-kind property or other property or money which is treated as transferred in exchange for the like-kind property. For application of the section 1060 allocation rules to property which is not part of the like-kind exchange, see § 1.1060–1(b), (c), and (d) *Example 1 in § 1.338–6(b), to which reference is made by § 1.1060–1(c)(2)*.

[T.D. 8215, 53 FR 27044, July 18, 1988, as amended by T.D. 8858, 65 FR 1237, Jan. 7, 2000; T.D. 8940, 66 FR 9929, Feb. 13, 2001]

§ 1.1031(d)–2 Treatment of assumption of liabilities.

For the purposes of section 1031(d), the amount of any liabilities of the taxpayer assumed by the other party to the exchange (or of any liabilities to which the property exchanged by the taxpayer is subject) is to be treated as money received by the taxpayer upon the exchange, whether or not the assumption resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made. The application of this section may be illustrated by the following examples:

Example 1. B, an individual, owns an apartment house which has an adjusted basis in his hands of $500,000, but which is subject to a mortgage of $150,000. On September 1, 1954, he transfers the apartment house to C, receiving in exchange therefor $50,000 in cash and another apartment house with a fair market value on that date of $600,000. The transfer to C is made subject to the $150,000 mortgage. B realizes a gain of $300,000 on the exchange, computed as follows:

Value of property received	$600,000
Cash	50,000
Liabilities subject to which old property was transferred	150,000
Total consideration received	800,000
Less: Adjusted basis of property transferred	500,000
Gain realized	300,000

Under section 1031(b), $200,000 of the $300,000 gain is recognized. The basis of the apartment house acquired by B upon the exchange is $500,000, computed as follows:

Adjusted basis of property transferred		500,000
Less: Amount of money received:		
Cash	$50,000	
Amount of liabilities subject to which property was transferred	150,000	
		200,000
Difference		300,000
Plus: Amount of gain recognized upon the exchange		200,000
Basis of property acquired upon the exchange		500,000

Example 2. (a) D, an individual, owns an apartment house. On December 1, 1955, the apartment house owned by D has an adjusted basis in his hands of $100,000, a fair market value of $220,000, but is subject to a mortgage of $80,000. E, an individual, also owns an apartment house. On December 1, 1955, the apartment house owned by E has an adjusted basis of $175,000, a fair market value of $250,000, but is subject to a mortgage of $150,000. On December 1, 1955, D transfers his apartment house to E, receiving in exchange therefore $40,000 in cash and the apartment house owned by E. Each apartment house is transferred subject to the mortgage on it.

(b) D realizes a gain of $120,000 on the exchange, computed as follows:

Value of property received		$250,000
Cash		40,000
Liabilities subject to which old property was transferred		80,000
Total consideration received		370,000
Less:		
Adjusted basis of property transferred	$100,000	
Liabilities to which new property is subject	150,000	
		250,000
Gain realized		120,000

For purposes of section 1031(b), the amount of *other property or money* received by D is $40,000. (Consideration received by D in the form of a transfer subject to a liability of $80,000 is offset by consideration given in the form of a receipt of property subject to a $150,000 liability. Thus, only the consideration received in the form of cash, $40,000, is treated as *other property or money* for purposes of section 1031(b).) Accordingly, under section 1031(b), $40,000 of the $120,000 gain is recognized. The basis of the apartment house acquired by D is $170,000, computed as follows:

Adjusted basis of property transferred	$100,000

Liabilities to which new property is subject		150,000
Total		250,000
Less:		
Amount of money received: Cash	$40,000	
Amount of liabilities subject to which property was transferred	80,000	
		120,000
Difference		130,000
Plus: Amount of gain recognized upon the exchange		40,000
Basis of property acquired upon the exchange		170,000

(c) E realizes a gain of $75,000 on the exchange, computed as follows:

Value of property received		$220,000
Liabilities subject to which old property was transferred		150,000
Total consideration received		370,000
Less:		
Adjusted basis of property transferred	$175,000	
Cash	40,000	
Liabilities to which new property is subject	80,000	
		295,000
Gain realized		75,000

For purposes of section 1031(b), the amount of *other property or money* received by E is $30,000. (Consideration received by E in the form of a transfer subject to a liability of $150,000 is offset by consideration given in the form of a receipt of property subject to an $80,000 liability and by the $40,000 cash paid by E. Although consideration received in the form of cash or other property is not offset by consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability, consideration given in the form of cash or other property is offset against consideration received in the form of an assumption of liabilities or a transfer of property subject to a liability.) Accordingly, under section 1031(b), $30,000 of the $75,000 gain is recognized. The basis of the apartment house acquired by E is $175,000, computed as follows:

Adjusted basis of property transferred		$175,000
Cash		40,000
Liabilities to which new property is subject		80,000
Total		295,000
Less:		
Amount of money received: Amount of liabilities subject to which property was transferred	$150,000	
		150,000
Difference		145,000
Plus: Amount of gain recognized upon the exchange		30,000
Basis of property acquired upon the exchange		175,000

§ 1.1031(e)–1 Exchange of livestock of different sexes.

Section 1031(e) provides that livestock of different sexes are not property of like kind. Section 1031(e) and this section are applicable to taxable years to which the Internal Revenue Code of 1954 applies.

[T.D. 7141, 36 FR 18792, Sept. 22, 1971]

§ 1.1031(j)–1 Exchanges of multiple properties.

(a) *Introduction*—(1) *Overview*. As a general rule, the application of section 1031 requires a property-by-property comparison for computing the gain recognized and basis of property received in a like-kind exchange. This section provides an exception to this general rule in the case of an exchange of multiple properties. An exchange is an exchange of multiple properties if, under paragraph (b)(2) of this section, more than one exchange group is created. In addition, an exchange is an exchange of multiple properties if only one exchange group is created but there is more than one property being transferred or received within that exchange group. Paragraph (b) of this section provides rules for computing the amount of gain recognized in an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031. Paragraph (c) of this section provides rules for computing the basis of properties received in an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031.

(2) *General approach.* (i) In general, the amount of gain recognized in an exchange of multiple properties is computed by first separating the properties transferred and the properties received by the taxpayer in the exchange into exchange groups in the manner described in paragraph (b)(2) of this section. The separation of the properties transferred and the properties received in the exchange into exchange groups involves matching up properties of a like kind of like class to the extent possible. Next, all liabilities assumed by the taxpayer as part of the transaction are offset by all liabilities of which the taxpayer is relieved as part of the transaction, with the excess liabilities assumed or relieved allocated in accordance with paragraph (b)(2)(ii) of this section. Then, the rules of section 1031 and the regulations thereunder are applied separately to each exchange group to determine the amount of gain recognized in the exchange. See §§ 1.1031(b)–1 and 1.1031(c)–1. Finally, the rules of section 1031 and the regulations thereunder are applied separately to each exchange group to determine the basis of the properties received in the exchange. See §§ 1.1031(d)–1 and 1.1031(d)–2.

(ii) For purposes of this section, the exchanges are assumed to be made at arms' length, so that the aggregate fair market value of the property received in the exchange equals the aggregate fair market value of the property transferred. Thus, the amount realized with respect to the properties transferred in each exchange group is assumed to equal their aggregate fair market value.

(b) *Computation of gain recognized*—(1) *In general.* In computing the amount of gain recognized in an exchange of multiple properties, the fair market value must be determined for each property transferred and for each property received by the taxpayer in the exchange. In addition, the adjusted basis must be determined for each property transferred by the taxpayer in the exchange.

(2) *Exchange groups and residual group.* The properties transferred and the properties received by the taxpayer in the exchange are separated into exchange groups and a residual group to the extent provided in this paragraph (b)(2).

(i) *Exchange groups.* Each exchange group consists of the properties transferred and received in the exchange, all of which are of a like kind or like class. If a property could be included in more than one exchange group, the taxpayer may include the property in any of those exchange groups. Property eligible for inclusion within an exchange group does not include money or property described in section 1031(a)(2) (i.e., stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action). For example, an exchange group may consist of all exchanged properties that are within the same General Asset Class or within the same Product Class (as defined in § 1.1031(a)–2(b)). Each exchange group must consist of at least one property transferred and at least one property received in the exchange.

(ii) *Treatment of liabilities.* (A) All liabilities assumed by the taxpayer as part of the exchange are offset against all liabilities of which the taxpayer is relieved as part of the exchange, regardless of whether the liabilities are recourse or nonrecourse and regardless of whether the liabilities are secured by or otherwise relate to specific property transferred or received as part of the exchange. See §§ 1.1031 (b)–1(c) and 1.1031(d)–2. For purposes of this section, liabilities assumed by the taxpayer as part of the exchange consist of liabilities of the other party to the exchange assumed by the taxpayer and liabilities subject to which the other party's property is transferred in the exchange. Similarly, liabilities of which the taxpayer is relieved as part of the exchange consist of liabilities of the taxpayer assumed by the other party to the exchange and liabilities subject to which the taxpayer's property is transferred.

(B) If there are excess liabilities assumed by the taxpayer as part of the exchange (i.e., the amount of liabilities assumed by the taxpayer exceeds the amount of liabilities of which the taxpayer is relieved), the excess is allocated among the exchange groups (but

not to the residual group) in proportion to the aggregate fair market value of the properties received by the taxpayer in the exchange groups. The amount of excess liabilities assumed by the taxpayer that are allocated to each exchange group may not exceed the aggregate fair market value of the properties received in the exchange group.

(C) If there are excess liabilities of which the taxpayer is relieved as part of the exchange (i.e., the amount of liabilities of which the taxpayer is relieved exceeds the amount of liabilities assumed by the taxpayer), the excess is treated as a Class I asset for purposes of making allocations to the residual group under paragraph (b)(2)(iii) of this section.

(D) Paragraphs (b)(2)(ii) (A), (B), and (C) of this section are applied in the same manner even if section 1031 and this section apply to only a portion of a larger transaction (such as a transaction described in section 1060(c) and §1.1060–1T(b)). In that event, the amount of excess liabilities assumed by the taxpayer or the amount of excess liabilities of which the taxpayer is relieved is determined based on all liabilities assumed by the taxpayer and all liabilities of which the taxpayer is relieve as part of the larger transaction.

(iii) *Residual group.* If the aggregate fair market value of the properties transferred in all of the exchange groups differs from the aggregate fair market value of the properties received in all of the exchange groups (taking liabilities into account in the manner described in paragraph (b)(2)(ii) of this section), a residual group is created. The residual group consists of an amount of money or other property having an aggregate fair market value equal to that difference. The residual group consists of either money or other property transferred in the exchange or money or other property received in the exchange, but not both. For this purpose, other property includes property described in section 1031(a)(2) (i.e., stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action), property transferred that is not of a like kind or like class with any property received, and property received that is not of a like kind or like class with any property transferred. The money and properties that are allocated to the residual group are considered to come from the following assets in the following order: first from Class I assets, then from Class II assets, then from Class III assets, and then from Class IV assets. The terms Class I assets, Class II assets, Class III assets, and Class IV assets have the same meanings as in §1.338–6(b), to which reference is made by §1.1060–1(c)(2). Within each Class, taxpayers may choose which properties are allocated to the residual group.

(iv) *Exchange group surplus and deficiency.* For each of the exchange groups described in this section, an ''exchange group surplus'' or ''exchange group deficiency,'' if any, must be determined. An exchange group surplus is the excess of the aggregate fair market value of the properties received (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group), in an exchange group over the aggregate fair market value of the properties transferred in that exchange group. An exchange group deficiency is the excess of the aggregate fair market value of the properties transferred in an exchange group over the aggregate fair market value of the properties received (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group) in that exchange group.

(3) *Amount of gain recognized.* (i) For purposes of this section, the amount of gain or loss realized with respect to each exchange group and the residual group is the difference between the aggregate fair market value of the properties transferred in that exchange group or residual group and the properties' aggregate adjusted basis. The gain realized with respect to each exchange group is recognized to the extent of the lesser of the gain realized and the amount of the exchange group deficiency, if any. Losses realized with respect to an exchange group are not recognized. See section 1031 (a) and (c). The total amount of gain recognized under section 1031 in the exchange is

the sum of the amount of gain recognized with respect to each exchange group. With respect to the residual group, the gain or loss realized (as determined under this section) is recognized as provided in section 1001 or other applicable provision of the Code.

(ii) The amount of gain or loss realized and recognized with respect to properties transferred by the taxpayer that are not within any exchange group or the residual group is determined under section 1001 and other applicable provisions of the Code, with proper adjustments made for all liabilities not allocated to the exchange groups or the residual group.

(c) *Computation of basis of properties received.* In an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031 and this section, the aggregate basis of properties received in each of the exchange groups is the aggregate adjusted basis of the properties transferred by the taxpayer within that exchange group, increased by the amount of gain recognized by the taxpayer with respect to that exchange group, increased by the amount of the exchange group surplus or decreased by the amount of the exchange group deficiency, and increased by the amount, if any, of excess liabilities assumed by the taxpayer that are allocated to that exchange group. The resulting aggregate basis of each exchange group is allocated proportionately to each property received in the exchange group in accordance with its fair market value. The basis of each property received within the residual group (other than money) is equal to its fair market value.

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

Example 1. (i) K exchanges computer A (asset class 00.12) and automobile A (asset class 00.22), both of which were held by K for productive use in its business, with W for printer B (asset class 00.12) and automobile B (asset class 00.22), both of which will be held by K for productive use in its business. K's adjusted basis and the fair market value of the exchanged properties are as follows:

	Adjusted basis	Fair market value
Computer A	$375	$1,000
Automobile A	1,500	4,000
Printer B		2,050
Automobile B		2,950

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A and printer B (both are within the same General Asset Class) and, as to K, has an exchange group surplus of $1050 because the fair market value of printer B ($2050) exceeds the fair market value of computer A ($1000) by that amount.

(B) The second exchange group consists of automobile A and automobile B (both are within the same General Asset Class) and, as to K, has an exchange group deficiency of $1050 because the fair market value of automobile A ($4000) exceeds the fair market value of automobile B ($2950) by that amount.

(iii) K recognizes gain on the exchange as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A ($1000) over its adjusted basis ($375), or $625. The amount of gain recognized is the lesser of the gain realized ($625) and the exchange group deficiency ($0), or $0.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A ($4000) over its adjusted basis ($1500), or $2500. The amount of gain recognized is the lesser of the gain realized ($2500) and the exchange group deficiency ($1050), or $1050.

(iv) The total amount of gain recognized by K in the exchange is the sum of the gains recognized with respect to both exchange groups ($0 + $1050), or $1050.

(v) The bases of the property received by K in the exchange, printer B and automobile B, are determined in the following manner:

(A) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within the exchange group ($375), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($1050), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $1425. Because printer B was the only property received within the first exchange group, the entire basis of $1425 is allocated to printer B.

(B) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($1500), increased by the amount of gain recognized with respect to that exchange group ($1050), decreased by the

amount of the exchange group deficiency ($1050), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $1500. Because automobile B was the only property received within the second exchange group, the entire basis of $1500 is allocated to automobile B.

Example 2. (i) F exchanges computer A (asset class 00.12) and automobile A (asset class 00.22), both of which were held by F for productive use in its business, with G for printer B (asset class 00.12) and automobile B (asset class 00.22), both of which will be held by F for productive use in its business, and corporate stock and $500 cash. The adjusted basis and fair market value of the properties are as follows:

	Adjusted basis	Fair market value
Computer A	$375	$1,000
Automobile A	3,500	4,000
Printer B		800
Automobile B		2,950
Corporate stock		750
Cash		500

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A and printer B (both are within the same General Asset Class) and, as to F, has an exchange group deficiency of $200 because the fair market value of computer A ($1000) exceeds the fair market value of printer B ($800) by that amount.

(B) The second exchange group consists of automobile A and automobile B (both are within the same General Asset Class) and, as to F, has an exchange group deficiency of $1050 because the fair market value of automobile A ($4000) exceeds the fair market value of automobile B ($2950) by that amount.

(C) Because the aggregate fair market value of the properties transferred by F in the exchange groups ($5,000) exceeds the aggregate fair market value of the properties received by F in the exchange groups ($3750) by $1250, there is a residual group in that amount consisting of the $500 cash and the $750 worth of corporate stock.

(iii) F recognizes gain on the exchange as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A ($1000) over its adjusted basis ($375), or $625. The amount of gain recognized is the lesser of the gain realized ($625) and the exchange group deficiency ($200), or $200.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A ($4000) over its adjusted basis ($3500), or $500. The amount of gain recognized is the lesser of the gain realized ($500) and the exchange group deficiency ($1050), or $500.

(C) No property transferred by F was allocated to the residual group. Therefore, F does not recognize gain or loss with respect to the residual group.

(iv) The total amount of gain recognized by F in the exchange is the sum of the gains recognized with respect to both exchange groups ($200 + $500), or $700.

(v) The bases of the properties received by F in the exchange (printer B, automobile B, and the corporate stock) are determined in the following manner:

(A) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($375), increased by the amount of gain recognized with respect to that exchange group ($200), decreased by the amount of the exchange group deficiency ($200), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $375. Because printer B was the only property received within the first exchange group, the entire basis of $375 is allocated to printer B.

(B) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($3500), increased by the amount of gain recognized with respect to that exchange group ($500), decreased by the amount of the exchange group deficiency ($1050), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $2950. Because automobile B was the only property received within the second exchange group, the entire basis of $2950 is allocated to automobile B.

(C) The basis of the property received within the residual group (the corporate stock) is equal to its fair market value or $750. Cash of $500 is also received within the residual group.

Example 3. (i) J and H enter into an exchange of the following properties. All of the property (except for the inventory) transferred by J was held for productive use in J's business. All of the property received by J will be held by J for productive use in its business.

J Transfers:			*H Transfers:*	
Property	Adjusted basis	Fair market value	Property	Fair market value
Computer A	$1,500	$5,000	Computer Z	$4,500
Computer B	500	3,000	Printer Y	2,500

J Transfers:			*H Transfers:*	
Property	Adjusted basis	Fair market value	Property	Fair market value
Printer C	2,000	1,500	Real Estate X	1,000
Real Estate D	1,200	2,000	Real Estate W	4,000
Real Estate E	0	1,800	Grader V	2,000
Scraper F	3,300	2,500	Truck T	1,700
Inventory	1,000	1,700	Cash	1,800
Total	9,500	17,500		17,500

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A, computer B, printer C, computer Z, and printer Y (all are within the same General Asset Class) and, as to J, has an exchange group deficiency of $2500 (($5000 + $3000 + $1500) − ($4500 + $2500)).

(B) The second exchange group consists of real estate D, E, X and W (all are of a like kind) and, as to J, has an exchange group surplus of $1200 (($1000 + $4000) − ($2000 + $1800)).

(C) The third exchange group consists of scraper F and grader V (both are within the same Product Class (NAICS code 333120)) and, as to J, has an exchange group deficiency of $500 ($2500 − $2000).

(D) Because the aggregate fair market value of the properties transferred by J in the exchange groups ($15,800) exceeds the aggregate fair market value of the properties received by J in the exchange groups ($14,000) by $1800, there is a residual group in that amount consisting of the $1800 cash (a Class I asset).

(E) The transaction also includes a taxable exchange of inventory (which is property described in section 1031 (a)(2)) for truck T (which is not of a like kind or like class to any property transferred in the exchange).

(iii) J recognizes gain on the transaction as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the aggregate fair market value of the properties transferred in the exchange group ($9500) over the aggregate adjusted basis ($4000), or $5500. The amount of gain recognized is the lesser of the gain realized ($5500) and the exchange group deficiency ($2500), or $2500.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the aggregate fair market value of the properties transferred in the exchange group ($3800) over the aggregate adjusted basis ($1200), or $2600. The amount of gain recognized is the lesser of the gain realized ($2600) and the exchange group deficiency ($0), or $0.

(C) With respect to the third exchange group, a loss is realized in the amount of $800 because the fair market value of the property transferred in the exchange group ($2500) is less than its adjusted basis ($3300). Although a loss of $800 was realized, under section 1031 (a) and (c) losses are not recognized.

(D) No property transferred by J was allocated to the residual group. Therefore, J does not recognize gain or loss with respect to the residual group.

(E) With respect to the taxable exchange of inventory for truck T, gain of $700 is realized and recognized by J (amount realized of $1700 (the fair market value of truck T) less the adjusted basis of the inventory ($1000)).

(iv) The total amount of gain recognized by J in the transaction is the sum of the gains recognized under section 1031 with respect to each exchange group ($2500 + $0 + $0) and any gain recognized outside of section 1031 ($700), or $3200.

(v) The bases of the property received by J in the exchange are determined in the following manner:

(A) The aggregate basis of the properties received in the first exchange group is the adjusted basis of the properties transferred within that exchange group ($4000), increased by the amount of gain recognized with respect to that exchange group ($2500), decreased by the amount of the exchange group deficiency ($2500), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $4000. This $4000 of basis is allocated proportionately among the assets received within the first exchange group in accordance with their fair market values: Computer Z's basis is $2571 ($4000 × $4500/$7000); printer Y's basis is $1429 ($4000 × $2500/$7000).

(B) The aggregate basis of the properties received in the second exchange group is the adjusted basis of the properties transferred within that exchange group ($1200), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($1200), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $2400. This $2400 of basis is allocated proportionately among the assets received within the second exchange group in accordance with their fair market values: Real estate X's basis is $480 ($2400 ×

$1000/$5000); real estate W's basis is $1920 ($2400 × $4000/$5000).

(c) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($3300), increased by the amount of gain recognized with respect to that exchange group ($0), decreased by the amount of the exchange group deficiency ($500), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $2800. Because grader V was the only property received within the third exchange group, the entire basis of $2800 is allocated to grader V.

(D) Cash of $1800 is received within the residual group.

(E) The basis of the property received in the taxable exchange (truck T) is equal to its cost of $1700.

Example 4. (i) B exchanges computer A (asset class 00.12), automobile A (asset class 00.22) and truck A (asset class 00.241), with C for computer R (asset class 00.12), automobile R (asset class 00.22), truck R (asset class 00.241) and $400 cash. All properties transferred by either B or C were held for productive use in the respective transferor's business. Similarly, all properties to be received by either B or C will be held for productive use in the respective recipient's business. Automobile A, automobile R and truck R are each secured by a nonrecourse liability and are transferred subject to such liability. The adjusted basis, fair market value, and liability secured by each property, if any, are as follows:

	Adjusted basis	Fair market value	Liability
B transfers:			
Computer A	$800	$1,500	$0
Automobile A	900	2,500	500
Truck A	700	2,000	0
C transfers:			
Computer R	1,100	1,600	0
Automobile R	2,100	3,100	750
Truck R	600	1,400	250
Cash		400	

(ii) The tax treatment to B is as follows:

(A)(*1*) The first exchange group consists of computers A and R (both are within the same General Asset Class).

(*2*) The second exchange group consists of automobiles A and R (both are within the same General Asset Class).

(*3*) The third exchange group consists of trucks A and R (both are in the same General Asset Class).

(B) Under paragraph (b)(2)(ii) of this section, all liabilities assumed by B ($1000) are offset by all liabilities of which B is relieved ($500), resulting in excess liabilities assumed of $500. The excess liabilities assumed of $500 is allocated among the exchange groups in proportion to the fair market value of the properties received by B in the exchange groups as follows:

(*1*) $131 of excess liabilities assumed ($500 × $1600/$6100) is allocated to the first exchange group. The first exchange group has an exchange group deficiency of $31 because the fair market value of computer A ($1500) exceeds the fair market value of computer R less the excess liabilities assumed allocated to the exchange group ($1600–$131) by that amount.

(*2*) $254 of excess liabilities assumed ($500 × $3100/$6100) is allocated to the second exchange group. The second exchange group has an exchange group surplus of $346 because the fair market value of automobile R less the excess liabilities assumed allocated to the exchange group ($3100–$254) exceeds the fair market value of automobile A ($2500) by that amount.

(*3*) $115 of excess liabilities assumed ($500 × $1400/$6100) is allocated to the third exchange group. The third exchange group has an exchange group deficiency of $715 because the fair market value of truck A ($2000) exceeds the fair market value of truck R less the excess liabilities assumed allocated to the exchange group ($1400–$115) by that amount.

(*4*) The difference between the aggregate fair market value of the properties transferred in all of the exchange groups, $6000, and the aggregate fair market value of the properties received in all of the exchange groups (taking excess liabilities assumed into account), $5600, is $400. Therefore there is a residual group in that amount consisting of $400 cash received.

(C) B recognizes gain on the exchange as follows:

(*1*) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A ($1500) over its adjusted basis ($800), or $700. The amount of gain recognized is the lesser of the gain realized ($700) and the exchange group deficiency ($31), or $31.

(*2*) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A ($2500) over its adjusted basis ($900), or $1600.

The amount of gain recognized is the lesser of the gain realized ($1600) and the exchange group deficiency ($0), or $0.

(*3*) With respect to the third exchange group, the amount of gain realized is the excess of the fair market value of truck A ($2000) over its adjusted basis ($700), or $1300. The amount of gain recognized is the lesser of gain realized ($1300) and the exchange group deficiency ($715), or $715.

(*4*) No property transferred by B was allocated to the residual group. Therefore, B does not recognize gain or loss with respect to the residual group.

(D) The total amount of gain recognized by B in the exchange is the sum of the gains

recognized under section 1031 with respect to each exchange group ($31 + $0 + $715), or $746.

(E) the bases of the property received by B in the exchange (computer R, automobile R, and truck R) are determined in the following manner:

(*1*) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($800), increased by the amount of gain recognized with respect to that exchange group ($31), decreased by the amount of the exchange group deficiency ($31), and increased by the amount of excess liabilities assumed allocated to that exchange group ($131), or $931. Because computer R was the only property received within the first exchange group, the entire basis of $931 is allocated to computer R.

(*2*) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($900), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($346), and increased by the amount of excess liabilities assumed allocated to that exchange group ($254), or $1500. Because automobile R was the only property received within the second exchange group, the entire basis of $1500 is allocated to automobile R.

(*3*) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($700), increased by the amount of gain recognized with respect to that exchange group ($715), decreased by the amount of the exchange group deficiency ($715), and increased by the amount of excess liabilities assumed allocated to that exchange group ($115), or $815. Because truck R was the only property received within the third exchange group, the entire basis of $815 is allocated to truck R.

(F) Cash of $400 is also received by B.

(iii) The tax treatment to C is as follows:

(A) (*1*) The first exchange group consists of computers R and A (both are within the same General Asset Class).

(*2*) The second exchange group consists of automobiles R and A (both are within the same General Asset Class).

(*3*) The third exchange group consists of trucks R and A (both are in the same General Asset Class).

(B) Under paragraph (b)(2)(ii) of this section, all liabilities of which C is relieved ($1000) are offset by all liabilities assumed by C ($500), resulting in excess liabilities relieved of $500. This excess liabilities relieved is treated as cash received by C.

(*1*) The first exchange group has an exchange group deficiency of $100 because the fair market value of computer R ($1600) exceeds the fair market value of computer A ($1500) by that amount.

(*2*) The second exchange group has an exchange group deficiency of $600 because the fair market value of automobile R ($3100) exceeds the fair market value of automobile A ($2500) by that amount.

(*3*) The third exchange group has an exchange group surplus of $600 because the fair market value of truck A ($2000) exceeds the fair market value of truck R ($1400) by that amount.

(*4*) The difference between the aggregate fair market value of the properties transferred by C in all of the exchange groups, $6100, and the aggregate fair market value of the properties received by C in all of the exchange groups, $6000, is $100. Therefore, there is a residual group in that amount, consisting of excess liabilities relieved of $100, which is treated as cash received by C.

(*5*) The $400 cash paid by C and $400 of the excess liabilities relieved which is treated as cash received by C are not within the exchange groups of the residual group.

(C) C recognizes gain on the exchange as follows:

(*1*) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer R ($1600) over its adjusted basis ($1100), or $500. The amount of gain recognized is the lesser of the gain realized ($500) and the exchange group deficiency ($100), or $100.

(*2*) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile R ($3100) over its adjusted basis ($2100), or $1000. The amount of gain recognized is the lesser of the gain realized ($1000) and the exchange group deficiency ($600), or $600.

(*3*) With respect to the third exchange group, the amount of gain realized is the excess of the fair market value of truck R ($1400) over its adjusted basis ($600), or $800. The amount of gain recognized is the lesser of gain realized ($800) and the exchange group deficiency ($0), or $0.

(*4*) No property transferred by C was allocated to the residual group. Therefore, C does not recognize any gain with respect to the residual group.

(D) The total amount of gain recognized by C in the exchange is the sum of the gains recognized under section 1031 with respect to each exchange group ($100 + $600 + $0), or $700.

(E) The bases of the properties received by C in the exchange (computer A, automobile A, and truck A) are determined in the following manner:

(*1*) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($1100), increased by the amount of gain recognized with respect to that exchange group ($100), decreased by the amount of the exchange group deficiency ($100), and increased by the amount of excess

liabilities assumed allocated to that exchange group ($0), or $1100. Because computer A was the only property received within the first exchange group, the entire basis of $1100 is allocated to computer A.

(*2*) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($2100), increased by the amount of gain recognized with respect to that exchange group ($600), decreased by the amount of the exchange group deficiency ($600), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $2100. Because automobile A was the only property received within the second exchange group, the entire basis of $2100 is allocated to automobile A.

(*3*) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($600), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($600), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $1200. Because truck A was the only property received within the third exchange group, the entire basis of $1200 is allocated to truck A.

Example 5. (i) U exchanges real estate A, real estate B, and grader A (NAICS code 333120) with V for real estate R and railroad car R (General Asset Class 00.25). All properties transferred by either U or V were held for productive use in the respective transferor's business. Similarly, all properties to be received by either U or V will be held for productive use in the respective recipient's business. Real estate R is secured by a recourse liability and is transferred subject to that liability. The adjusted basis, fair market value, and liability secured by each property, if any, are as follows:

	Adjusted basis	Fair market value	Liability
U Transfers:			
Real Estate A	$2000	$5000	.....
Real Estate B	8000	13,500	.....
Grader A	500	2000	.....
V Transfers:			
Real Estate R	$20,000	$26,500	$7000
Railroad car R	1200	1000	

(ii) The tax treatment to U is as follows:

(A) The exchange group consists of real estate A, real estate B, and real estate R.

(B) Under paragraph (b)(2)(ii) of this section, all liabilities assumed by U ($7000) are excess liabilities assumed. The excess liabilities assumed of $7000 is allocated to the exchange group.

(*1*) The exchange group has an exchange group surplus of $1000 because the fair market value of real estate R less the excess liabilities assumed allocated to the exchange group ($26,500–$7000) exceeds the aggregate fair market value of real estate A and B ($18,500) by that amount.

(*2*) The difference between the aggregate fair market value of the properties received in the exchange group (taking excess liabilities assumed into account), $19,500, and the aggregate fair market value of the properties transferred in the exchange group, $18,500, is $1000. Therefore, there is a residual group in that amount consisting of $1000 (or 50 percent of the fair market value) of grader A.

(*3*) The transaction also includes a taxable exchange of the 50 percent portion of grader A not allocated to the residual group (which is not of a like kind or like class to any property received by U in the exchange) for railroad car R (which is not of a like kind or like class to any property transferred by U in the exchange).

(C) U recognizes gain on the exchange as follows:

(*1*) With respect to the exchange group, the amount of the gain realized is the excess of the aggregate fair market value of real estate A and B ($18,500) over the aggregate adjusted basis ($10,000), or $8500. The amount of the gain recognized is the lesser of the gain realized ($8500) and the exchange group deficiency ($0), or $0.

(*2*) With respect to the residual group, the amount of gain realized and recognized is the excess of the fair market value of the 50 percent portion of grader A that is allocated to the residual group ($1000) over its adjusted basis ($250), or $750.

(*3*) With respect to the taxable exchange of the 50 percent portion of grader A not allocated to the residual group for railroad car R, gain of $750 is realized and recognized by U (amount realized of $1000 (the fair market value of railroad car R) less the adjusted basis of the 50 percent portion of grader A not allocated to the residual group ($250)).

(D) The total amount of gain recognized by U in the transaction is the sum of the gain recognized under section 1031 with respect to the exchange group ($0), any gain recognized with respect to the residual group ($750), and any gain recognized with respect to property transferred that is not in the exchange group or the residual group ($750), or $1500.

(E) The bases of the property received by U in the exchange (real estate R and railroad car R) are determined in the following manner:

(*1*) The basis of the property received in the exchange group is the aggregate adjusted basis of the property transferred within that exchange group ($10,000), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($1000), and increased by the amount of excess liabilities assumed allocated to that exchange group ($7000), or $18,000. Because real

estate R is the only property received within the exchange group, the entire basis of $18,000 is allocated to real estate R.

(*2*) The basis of railroad car R is equal to its cost of $1000.

(iii) The tax treatment to V is as follows:

(A) The exchange group consists of real estate R, real estate A, and real estate B.

(B) Under paragraph (b)(2)(ii) of this section, the liabilities of which V is relieved ($7000) results in excess liabilities relieved of $7000 and is treated as cash received by V.

(*1*) The exchange group has an exchange group deficiency of $8000 because the fair market value of real estate R ($26,500) exceeds the aggregate fair market value of real estate A and B ($18,500) by that amount.

(*2*) The difference between the aggregate fair market value of the properties transferred by V in the exchange group, $26,500, and the aggregate fair market value of the properties received by V in the exchange group, $18,500, is $8000. Therefore, there is a residual group in that amount, consisting of the excess liabilities relieved of $7000, which is treated as cash received by V, and $1000 (or 50 percent of the fair market value) of grader A.

(*3*) The transaction also includes a taxable exchange of railroad car R (which is not of a like kind or like class to any property received by V in the exchange) for the 50 percent portion of grader A (which is not of a like kind or like class to any property transferred by V in the exchange) not allocated to the residual group.

(C) V recognizes gain on the exchange as follows:

(*1*) With respect to the exchange group, the amount of the gain realized is the excess of the fair market value of real estate R ($26,500) over its adjusted basis ($20,000), or $6500. The amount of the gain recognized is the lesser of the gain realized ($6500) and the exchange group deficiency ($8000), or $6500.

(*2*) No property transferred by V was allocated to the residual group. Therefore, V does not recognize gain or loss with respect to the residual group.

(*3*) With respect to the taxable exchange of railroad car R for the 50 percent portion of grader A not allocated to the exchange group or the residual group, a loss is realized and recognized in the amount of $200 (the excess of the $1200 adjusted basis of railroad car R over the amount realized of $1000 (fair market value of the 50 percent portion of grader A)).

(D) The basis of the property received by V in the exchange (real estate A, real estate B, and grader A) are determined in the following manner:

(*1*) The basis of the property received in the exchange group is the adjusted basis of the property transferred within that exchange group ($20,000), increased by the amount of gain recognized with respect to that exchange group ($6500), and decreased by the amount of the exchange group deficiency ($8000), or $18,500. This $18,500 of basis is allocated proportionately among the assets received within the exchange group in accordance with their fair market values: real estate A's basis is $5000 ($18,500 × $5000/$18,500); real estate B's basis is $13,500 ($18,500 × $13,500/$18,500).

(*2*) The basis of grader A is $2000.

(e) *Effective date.* Section 1.1031 (j)–1 is effective for exchanges occurring on or after April 11, 1991.

[T.D. 8343, 56 FR 14855, Apr. 12, 1991, as amended by T.D. 8858, 65 FR 1237, Jan. 7, 2000; T.D. 8940, 66 FR 9929, Feb. 13, 2001; T.D. 9202, 70 FR 28820, May 19, 2005]

§ 1.1031(k)–1 Treatment of deferred exchanges.

(a) *Overview.* This section provides rules for the application of section 1031 and the regulations thereunder in the case of a ''deferred exchange.'' For purposes of section 1031 and this section, a deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the ''relinquished property'') and subsequently receives property to be held either for productive use in a trade or business or for investment (the ''replacement property''). In the case of a deferred exchange, if the requirements set forth in paragraphs (b), (c), and (d) of this section (relating to identification and receipt of replacement property) are not satisfied, the replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property. In order to constitute a deferred exchange, the transaction must be an exchange (i.e., a transfer of property for property, as distinguished from a transfer of property for money). For example, a sale of property followed by a purchase of property of a like kind does not qualify for nonrecognition of gain or loss under section 1031 regardless of whether the identification and receipt requirements of section 1031(a)(3) and paragraphs (b), (c), and (d) of this section are satisfied. The transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or property which does

not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). See §1.1031(a)–1(a)(2). In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) in the full amount of the consideration for the relinquished property, the transaction will constitute a sale, and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property. For purposes of this section, property which does not meet the requirements of section 1031(a) (whether by being described in section 1031(a)(2) or otherwise) is referred to as ''other property.'' For rules regarding actual and constructive receipt, and safe harbors therefrom, see paragraphs (f) and (g), respectively, of this section. For rules regarding the determination of gain or loss recognized and the basis of property received in a deferred exchange, see paragraph (j) of this section.

(b) *Identification and receipt requirements*—(1) *In general*. In the case of a deferred exchange, any replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property if—

(i) The replacement property is not ''identified'' before the end of the ''identification period,'' or

(ii) The identified replacement property is not received before the end of the ''exchange period.''

(2) *Identification period and exchange period*. (i) The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter.

(ii) The exchange period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the earlier of the 180th day thereafter or the due date (including extensions) for the taxpayer's return of the tax imposed by chapter 1 of subtitle A of the Code for the taxable year in which the transfer of the relinquished property occurs.

(iii) If, as part of the same deferred exchange, the taxpayer transfers more than one relinquished property and the relinquished properties are transferred on different dates, the identification period and the exchange period are determined by reference to the earliest date on which any of the properties are transferred.

(iv) For purposes of this paragraph (b)(2), property is transferred when the property is disposed of within the meaning of section 1001(a).

(3) *Example*. This paragraph (b) may be illustrated by the following example.

Example: (i) M is a corporation that files its Federal income tax return on a calendar year basis. M and C enter into an agreement for an exchange of property that requires M to transfer property X to C. Under the agreement, M is to identify like-kind replacement property which C is required to purchase and to transfer to M. M transfers property X to C on November 16, 1992.

(ii) The identification period ends at midnight on December 31, 1992, the day which is 45 days after the date of transfer of property X. The exchange period ends at midnight on March 15, 1993, the due date for M's Federal income tax return for the taxable year in which M transferred property X. However, if M is allowed the automatic six-month extension for filing its tax return, the exchange period ends at midnight on May 15, 1993, the day which is 180 days after the date of transfer of property X.

(c) *Identification of replacement property before the end of the identification period*—(1) *In general*. For purposes of paragraph (b)(1)(i) of this section (relating to the identification requirement), replacement property is identified before the end of the identification period only if the requirements of this paragraph (c) are satisfied with respect to the replacement property. However, any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

(2) *Manner of identifying replacement property*. Replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either—

(i) The person obligated to transfer the replacement property to the taxpayer (regardless of whether that person is a disqualified person as defined in paragraph (k) of this section); or

(ii) Any other person involved in the exchange other than the taxpayer or a disqualified person (as defined in paragraph (k) of this section).

Examples of persons involved in the exchange include any of the parties to the exchange, an intermediary, an escrow agent, and a title company. An identification of replacement property made in a written agreement for the exchange of properties signed by all parties thereto before the end of the identification period will be treated as satisfying the requirements of this paragraph (c)(2).

(3) *Description of replacement property*. Replacement property is identified only if it is unambiguously described in the written document or agreement. Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name (e.g., the Mayfair Apartment Building). Personal property generally is unambiguously described if it is described by a specific description of the particular type of property. For example, a truck generally is unambigously described if it is described by a specific make, model, and year.

(4) *Alternative and multiple properties.* (i) The taxpayer may identify more than one replacement property. Regardless of the number of relinguished properties transferred by the taxpayer as part of the same deferred exchange, the maximum number of replacement properties that the taxpayer may identify is—

(A) Three properties without regard to the fair market values of the properties (the ''3-property rule''), or

(B) Any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinguished properties as of the date the relinguished properties were transferred by the taxpayer (the ''200-percent rule'').

(ii) If, as of the end of the identification period, the taxpayer has identified more properties as replacement properties than permitted by paragraph (c)(4)(i) of this section, the taxpayer is treated as if no replacement property had been identified. The preceding sentence will not apply, however, and an identification satisfying the requirements of paragraph (c)(4)(i) of this section will be considered made, with respect to—

(A) Any replacement property received by the taxpayer before the end of the identification period, and

(B) Any replacement property identified before the end of the identification period and received before the end of the exchange period, but only if the taxpayer receives before the end of the exchange period identified replacement property the fair market vlaue of which is at least 95 percent of the aggregate fair market value of all identified replacement properties (the ''95-percent rule'').

For this purpose, the fair market value of each identified replacement property is determined as of the earlier of the date the property is received by the taxpayer or the last day of the exchange period.

(iii) For purposes of applying the 3-property rule, the 200-percent rule, and the 95-percent rule, all identifications of replacement property, other than identifications of replacement property that have been revoked in the manner provided in paragraph (c)(6) of this section, are taken into account. For example, if, in a deferred exchange, B transfers property X with a fair market value of $100,000 to C and B receives like-kind property Y with a fair market value of $50,000 before the end of the identification period, under paragraph (c)(1) of this section, property Y is treated as identified by reason of being received before the end of the identification period. Thus, under paragraph (c)(4)(i) of this section, B may identify either two additional replacement properties of any fair market

value or any number of additional replacement properties as long as the aggregate fair market value of the additional replacement properties does not exceed $150,000.

(5) *Incidental property disregarded.* (i) Solely for purposes of applying this paragraph (c), property that is incidental to a larger item of property is not treated as property that is separate from the larger item of property. Property is incidental to a larger item of property if—

(A) In standard commercial transactions, the property is typically transferred together with the larger item of property, and

(B) The aggregate fair market value of all of the incidental property does not exceed 15 percent of the aggregate fair market value of the larger item of property.

(ii) This paragraph (c)(5) may be illustrated by the following examples.

Example 1. For purposes of paragraph (c) of this section, a spare tire and tool kit will not be treated as separate property from a truck with a fair market value of $10,000, if the aggregate fair market value of the spare tire and tool kit does not exceed $1,500. For purposes of the 3-property rule, the truck, spare tire, and tool kit are treated as 1 property. Moreover, for purposes of paragraph (c)(3) of this section (relating to the description of replacement property), the truck, spare tire, and tool kit are all considered to be unambiguously described if the make, model, and year of the truck are specified, even if no reference is made to the spare tire and tool kit.

Example 2. For purposes of paragraph (c) of this section, furniture, laundry machines, and other miscellaneous items of personal property will not be treated as separate property from an apartment building with a fair market value of $1,000,000, if the aggregate fair market value of the furniture, laundry machines, and other personal property does not exceed $150,000. For purposes of the 3-property rule, the apartment building, furniture, laundry machines, and other personal property are treated as 1 property. Moreover, for purposes of paragraph (c)(3) of this section (relating to the description of replacement property), the apartment building, furniture, laundry machines, and other personal property are all considered to be unambiguously described if the legal description, street address, or distinguishable name of the apartment building is specified, even if no reference is made to the furniture, laundry machines, and other personal property.

(6) *Revocation of identification.* An identification of replacement property may be revoked at any time before the end of the identification period. An identification of replacement property is revoked only if the revocation is made in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or othewise sent before the end of the identification period to the person to whom the identification of the replacement property was sent. An identification of replacement property that is made in a written agreement for the exchange of properties is treated as revoked only if the revocation is made in a written amendment to the agreement or in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or othewise sent before the end of the identification period to all of the parties to the agreement.

(7) *Examples.* This paragraph (c) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. No replacement property is identified in the agreement. When subsequently identified, the replacement property is described by legal description and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to

hold the replacement property received for investment.

Example 1. (i) On July 2, 1991, B identifies real property E as replacement property by designating real property E as replacement property in a written document signed by B and personally delivered to C.

(ii) Because the identification was made after the end of the identification period, pursuant to paragraph (b)(1)(i) of this section (relating to the identification requirement), real property E is treated as property which is not of a like kind to real property X.

Example 2. (i) C is a corporation of which 20 percent of the outstanding stock is owned by B. On July 1, 1991, B identifies real property F as replacement property by designating real property F as replacement property in a written document signed by B and mailed to C.

(ii) Because C is the person obligated to transfer the replacement property to B, real property F is identified before the end of the identification period. The fact that C is a ''disqualified person'' as defined in paragraph (k) of this section does not change this result.

(iii) Real property F would also have been treated as identified before the end of the identification period if, instead of sending the identification to C, B had designated real property F as replacement property in a written agreement for the exchange of properties signed by all parties thereto on or before July 1, 1991.

Example 3. (i) On June 3, 1991, B identifies the replacement property as ''unimproved land located in Hood County with a fair market value not to exceed $100,000.'' The designation is made in a written document signed by B and personally delivered to C. On July 8, 1991, B and C agree that real property G is the property described in the June 3, 1991 document.

(ii) Because real property G was not unambiguously described before the end of the identification period, no replacement property is identified before the end of the identification period.

Example 4. (i) On June 28, 1991, B identifies real properties H, J, and K as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. The written document provides that by August 1, 1991, B will orally inform C which of the identified properties C is to transfer to B. As of July 1, 1991, the fair market values of real properties H, J, and K are $75,000, $100,000, and $125,000, respectively.

(ii) Because B did not identify more than three properties as replacement properties, the requirements of the 3-property rule are satisfied, and real properties H, J, and K are all identified before the end of the identification period.

Example 5. (i) On May 17, 1991, B identifies real properties L, M, N, and P as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. The written document provides that by July 2, 1991, B will orally inform C which of the identified properties C is to transfer to B. As of July 1, 1991, the fair market values of real properties L, M, N, and P are $30,000, $40,000, $50,000, and $60,000, respectively.

(ii) Although B identified more than three properties as replacement properties, the aggregate fair market value of the identified properties as of the end of the identification period ($180,000) did not exceed 200 percent of the aggregate fair market value of real property X (200% × $100,000 = $200,000). Therefore, the requirements of the 200-percent rule are satisfied, and real properties L, M, N, and P are all identified before the end of the identification period.

Example 6. (i) On June 21, 1991, B identifies real properties Q, R, and S as replacement properties by designating these properties as replacement properties in a written document signed by B and mailed to C. On June 24, 1991, B identifies real properties T and U as replacement properties in a written document signed by B and mailed to C. On June 28, 1991, B revokes the identification of real properties Q and R in a written document signed by B and personally delivered to C.

(ii) B has revoked the identification of real properties Q and R in the manner provided by paragraph (c)(6) of this section. Identifications of replacement property that have been revoked in the manner provided by paragraph (c)(6) of this section are not taken into account for purposes of applying the 3-property rule. Thus, as of June 28, 1991, B has identified only replacement properties S, T, and U for purposes of the 3-property rule. Because B did not identify more than three properties as replacement properties for purposes of the 3-property rule, the requirements of that rule are satisfied, and real properties S, T, and U are all identified before the end of the identification period.

Example 7. (i) On May 20, 1991, B identifies real properties V and W as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. On June 4, 1991, B identifies real properties Y and Z as replacement properties in the same manner. On June 5, 1991, B telephones C and orally revokes the identification of real properties V and W. As of July 1, 1991, the fair market values of real properties V, W, Y, and Z are $50,000, $70,000, $90,000, and $100,000, respectively. On July 31, 1991, C purchases real property Y and Z and transfers them to B.

(ii) Pursuant to paragraph (c)(6) of this section (relating to revocation of identification), the oral revocation of the identification of real properties V and W is invalid. Thus, the identification of real properties V and W is taken into account for purposes of determining whether the requirements of paragraph (c)(4) of this section (relating to the identification of alternative and multiple properties) are satisfied. Because B identified more than three properties and the aggregate fair market value of the identified properties as of the end of the identification period ($310,000) exceeds 200 percent of the fair market value of real property X (200% × $100,000 = $200,000), the requirements of paragraph (c)(4) of this section are not satisfied, and B is treated as if B did not identify any replacement property.

(d) *Receipt of identified replacement property*—(1) *In general*. For purposes of paragraph (b)(1)(ii) of this section (relating to the receipt requirement), the identified replacement property is received before the end of the exchange period only if the requriements of this paragraph (d) are satisfied with respect to the replacement property. In the case of a deferred exchange, the identified replacement property is received before the end of the exchange period if—

(i) The taxpayer receives the replacement property before the end of the exchange period, and

(ii) The replacement property received is substantially the same property as identified.

If the taxpayer has identified more than one replacement property, section 1031(a)(3)(B) and this paragraph (d) are applied separately to each replacement property.

(2) *Examples*. This paragraph (d) may be illustrated by the following examples. The following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. The replacement property is identified in a manner that satisfies paragraph (c) of this section (relating to identification of replacement property) and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

Example 1. (i) In the agreement, B identifies real properties J, K, and L as replacement properties. The agreement provides that by July 26, 1991, B will orally inform C which of the properties C is to transfer to B.

(ii) As of July 1, 1991, the fair market values of real properties J, K, and L are $75,000, $100,000, and $125,000, respectively. On July 26, 1991, B instructs C to acquire real property K. On October 31, 1991, C purchases real property K for $100,000 and transfers the property to B.

(iii) Because real property K was identified before the end of the identification period and was received before the end of the exchange period, the identification and receipt requirements of section 1031(a)(3) and this section are satisfied with respect to real property K.

Example 2. (i) In the agreement, B identifies real property P as replacement property. Real property P consists of two acres of unimproved land. On October 15, 1991, the owner of real property P erects a fence on the property. On November 1, 1991, C purchases real property P and transfers it to B.

(ii) The erection of the fence on real property P subsequent to its identification did not alter the basic nature or character of real property P as unimproved land. B is considered to have received substantially the same property as identified.

Example 3. (i) In the agreement, B identifies real property Q as replacement property. Real property Q consists of a barn on two acres of land and has a fair market value of $250,000 ($187,500 for the barn and underlying land and $62,500 for the remaining land). As of July 26, 1991, real property Q remains unchanged and has a fair market value of $250,000. On that date, at B's direction, C purchases the barn and underlying land for $187,500 and transfers it to B, and B pays $62,500 to C.

(ii) The barn and underlying land differ in basic nature or character from real property

Q as a whole, B is not considered to have received substantially the same property as identified.

Example 4. (i) In the agreement, B identifies real property R as replacement property. Real property R consists of two acres of unimproved land and has a fair market value of $250,000. As of October 3, 1991, real property R remains unimproved and has a fair market value of $250,000. On that date, at B's direction, C purchases 1½ acres of real property R for $187,500 and transfers it to B, and B pays $62,500 to C.

(ii) The portion of real property R that B received does not differ from the basic nature or character of real property R as a whole. Moreover, the fair market value of the portion of real property R that B received ($187,500) is 75 percent of the fair market value of real property R as of the date of receipt. Accordingly, B is considered to have received substantially the same property as identified.

(e) *Special rules for identification and receipt of replacement property to be produced*—(1) *In general.* A transfer of relinquished property in a deferred exchange will not fail to qualify for nonrecognition of gain or loss under section 1031 merely because the replacement property is not in existence or is being produced at the time the property is identified as replacement property. For purposes of this paragraph (e), the terms ''produced'' and ''production'' have the same meanings as provided in section 263A(g)(1) and the regulations thereunder.

(2) *Identification of replacement property to be produced.* (i) In the case of replacement property that is to be produced, the replacement property must be identified as provided in paragraph (c) of this section (relating to identification of replacement property). For example, if the identified replacement property consists of improved real property where the improvements are to be constructed, the description of the replacement property satisfies the requirements of paragraph (c)(3) of this section (relating to description of replacement property) if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time the identification is made.

(ii) For purposes of paragraphs (c)(4)(i)(B) and (c)(5) of this section (relating to the 200-percent rule and incidental property), the fair market value of replacement property that is to be produced is its estimated fair market value as of the date it is expected to be received by the taxpayer.

(3) *Receipt of replacement property to be produced.* (i) For purposes of paragraph (d)(1)(ii) of this section (relating to receipt of the identified replacement property), in determining whether the replacement property received by the taxpayer is substantially the same property as identified where the identified replacement property is property to be produced, variations due to usual or typical production changes are not taken into account. However, if substantial changes are made in the property to be produced, the replacement property received will not be considered to be substantially the same property as identified.

(ii) If the identified replacement property is personal property to be produced, the replacement property received will not be considered to be substantially the same property as identified unless production of the replacement property received is completed on or before the date the property is received by the taxpayer.

(iii) If the identified replacement property is real property to be produced and the production of the property is not completed on or before the date the taxpayer receives the property, the property received will be considered to be substantially the same property as identified only if, had production been completed on or before the date the taxpayer receives the replacement property, the property received would have been considered to be substantially the same property as identified. Even so, the property received is considered to be substantially the same property as identified only to the extent the property received constitutes real property under local law.

(4) *Additional rules.* The transfer of relinquished property is not within the provisions of section 1031(a) if the relinquished property is transferred in exchange for services (including production services). Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer

will not be treated as the receipt of property of a like kind.

(5) *Example*. This paragraph (e) may be illustrated by the following example.

Example: (i) B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers improved real property X and personal property Y to C on May 17, 1991. On or before November 13, 1991 (the end of the exchange period), C is required to transfer to B real property M, on which C is constructing improvements, and personal property N, which C is producing. C is obligated to complete the improvements and production regardless of when properties M and N are transferred to B. Properties M and N are identified in a manner that satisfies paragraphs (c) (relating to identification of replacement property) and (e)(2) of this section. In addition, properties M and N are of a like kind, respectively, to real property X and personal property Y (determined without regard to section 1031(a)(3) and this section). On November 13, 1991, when construction of the improvements to property M is 20 percent completed and the production of property N is 90 percent completed, C transfers to B property M and property N. If construction of the improvements had been completed, property M would have been considered to be substantially the same property as identified. Under local law, property M constitutes real property to the extent of the underlying land and the 20 percent of the construction that is completed.

(ii) Because property N is personal property to be produced and production of property N is not completed before the date the property is received by B, property N is not considered to be substantially the same property as identified and is treated as property which is not of a like kind to property Y.

(iii) Property M is considered to be substantially the same property as identified to the extent of the underlying land and the 20 percent of the construction that is completed when property M is received by B. However, any additional construction performed by C with respect to property M after November 13, 1991, is not treated as the receipt of property of a like kind.

(f) *Receipt of money or other property*—(1) *In general*. A transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or other property. However, such a transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). See §1.1031(a)–1(a)(2). In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

(2) *Actual and constructive receipt*. Except as provided in paragraph (g) of this section (relating to safe harbors), for purposes of section 1031 and this section, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. The taxpayer is in actual receipt of money or property at the time the taxpayer actually receives the money or property or receives the economic benefit of the money or property. The taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given. Although the taxpayer is not in constructive receipt of money or property if the taxpayer's control of its receipt is subject to substantial limitations or restrictions, the taxpayer is in constructive receipt of the money or property at the time the limitations or restrictions lapse, expire, or are waived. In addition, actual or constructive receipt of money or property by an agent of the taxpayer (determined without regard to paragraph (k) of this section) is actual or constructive receipt by the taxpayer.

(3) *Example*. This paragraph (f) may be illustrated by the following example.

Example: (i) B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to the agreement, on May 17, 1991, B transfers real property X to C. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. At any time after May 17, 1991, and before C has purchased the replacement property, B has the right, upon notice, to demand that C pay $100,000 in lieu of acquiring and transferring the replacement property. Pursuant to the agreement, B identifies replacement property, and C purchases the replacement property and transfers it to B.

(ii) Under the agreement, B has the unrestricted right to demand the payment of $100,000 as of May 17, 1991. B is therefore in constructive receipt of $100,000 on that date. Because B is in constructive receipt of money in the full amount of the consideration for the relinquished property before B actually receives the like-kind replacement property, the transaction constitutes a sale, and the transfer of real property X does not qualify for nonrecognition of gain or loss under section 1031. B is treated as if B received the $100,000 in consideration for the sale of real property X and then purchased the like-kind replacement property.

(iii) If B's right to demand payment of the $100,000 were subject to a substantial limitation or restriction (e.g., the agreement provided that B had no right to demand payment before November 14, 1991 (the end of the exchange period)), then, for purposes of this section, B would not be in actual or constructive receipt of the money unless (or until) the limitation or restriction lapsed, expired, or was waived.

(g) *Safe harbors*—(1) *In general*. Paragraphs (g)(2) through (g)(5) of this section set forth four safe harbors the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money or other property for purposes of section 1031 and this section. More than one safe harbor can be used in the same deferred exchange, but the terms and conditions of each must be separately satisfied. For purposes of the safe harbor rules, the term ''taxpayer'' does not include a person or entity utilized in a safe harbor (e.g., a qualified intermediary). See paragraph (g)(8), *Example 3(v)*, of this section.

(2) *Security or guarantee arrangements*. (i) In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured or guaranteed by one or more of the following—

(A) A mortgage, deed of trust, or other security interest in property (other than cash or a cash equivalent),

(B) A standby letter of credit which satisfies all of the requirements of § 15A.453–1 (b)(3)(iii) and which may not be drawn upon in the absence of a default of the transferee's obligation to transfer like-kind replacement property to the taxpayer, or

(C) A guarantee of a third party.

(ii) Paragraph (g)(2)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive money or other property pursuant to the security or guarantee arrangement.

(3) *Qualified escrow accounts and qualified trusts*. (i) In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured by cash or a cash equivalent if the cash or cash equivalent is held in a qualified escrow account or in a qualified trust.

(ii) A qualified escrow account is an escrow account wherein—

(A) The escrow holder is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and

(B) The escrow agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent

held in the escrow account as provided in paragraph (g)(6) of this section.

(iii) A qualified trust is a trust wherein—

(A) The trustee is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section, except that for this purpose the relationship between the taxpayer and the trustee created by the qualified trust will not be considered a relationship under section 267(b)), and

(B) The trust agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held by the trustee as provided in paragraph (g)(6) of this section.

(iv) Paragraph (g)(3)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the qualified escrow account or qualified trust. Rights conferred upon the taxpayer under state law to terminate or dismiss the escrow holder of a qualified escrow account or the trustee of a qualified trust are disregarded for this purpose.

(v) A taxpayer may receive money or other property directly from a party to the exchange, but not from a qualified escrow account or a qualified trust, without affecting the application of paragraph (g)(3)(i) of this section.

(4) *Qualified intermediaries.* (i) In the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer.

(ii) Paragraph (g)(4)(i) of this section applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in paragraph (g)(6) of this section.

(iii) A qualified intermediary is a person who—

(A) Is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and

(B) Enters into a written agreement with the taxpayer (the ''exchange agreement'') and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

(iv) Regardless of whether an intermediary acquires and transfers property under general tax principals, solely for purposes of paragraph (g)(4)(iii)(B) of this section—

(A) An intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property,

(B) An intermediary is treated as acquiring and transferring the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person, and

(C) An intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer.

(v) Solely for purposes of paragraphs (g)(4)(iii) and (g)(4)(iv) of this section, an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevent transfer of property. For example, if a taxpayer enters into

an agreement for the transfer of relinquished property and thereafter assigns its rights in that agreement to an intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the intermediary is treated as having acquired and transferred the relinquished property.

(vi) Paragraph (g)(4)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. Rights conferred upon the taxpayer under state law to terminate or dismiss the qualified intermediary are disregarded for this purpose.

(vii) A taxpayer may receive money or other property directly from a party to the transaction other than the qualified intermediary without affecting the application of paragraph (g)(4)(i) of this section.

(5) *Interest and growth factors.* In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives the like-kind replacement property will be made without regard to the fact that the taxpayer is or may be entitled to receive any interest or growth factor with respect to the deferred exchange. The preceding sentence applies only if the agreement pursuant to which the taxpayer is or may be entitled to the interest or growth factor expressly limits the taxpayer's rights to receive the interest or growth factor as provided in paragragh (g)(6) of this section. For additional rules concerning interest or growth factors, see paragraph (h) of this section.

(6) *Additional restrictions on safe harbors under paragraphs (g)(3) through (g)(5).* (i) An agreement limits a taxpayer's rights as provided in this paragraph (g)(6) only if the agreement provides that the taxpayer has no rights, except as provided in paragraph (g)(6)(ii) and (g)(6)(iii) of this section, to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.

(ii) The agreement may provide that if the taxpayer has not identified replacement property by the end of the identification period, the taxpayer may have rights to receive, pledge, borrow, or othewise obtain the benefits of money or other property at any time after the end of the identification period.

(iii) The agreement may provide that if the taxpayer has identified replacement property, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property upon or after—

(A) The receipt by the taxpayer of all of the replacement property to which the taxpayer is entitled under the exchange agreement, or

(B) The occurrence after the end of the identification period of a material and substantial contingency that—

(*1*) Relates to the deferred exchange,

(*2*) Is provided for in writing, and

(*3*) Is beyond the control of the taxpayer and of any disqualified person (as defined in paragraph (k) of this section), other than the person obligated to transfer the replacement property to the taxpayer.

(7) *Items disregarded in applying safe harbors under paragraphs (g)(3) through (g)(5).* In determining whether a safe harbor under paragraphs (g)(3) through (g)(5) of this section ceases to apply and whether the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property are expressly limited as provided in paragraph (g)(6) of this section, the taxpayer's receipt of or right to receive any of the following items will be disregarded—

(i) Items that a seller may receive as a consequence of the disposition of property and that are not included in the amount realized from the disposition of property (e.g., prorated rents);

(ii) Transactional items that relate to the disposition of the relinquished property or to the acquisition of the replacement property and appear under local standards in the typical closing statements as the responsibility of a

buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees); and

(iii) Personal property generally resulting in gain recognition under section 1031(b) that is incidental to real property acquired in an exchange. For purposes of this paragraph (g)(7), personal property is incidental to real property acquired in an exchange if—

(A) In standard commercial transactions, the personal property is typically transferred together with the real property; and

(B) The aggregate fair market value of the property described in paragraph (g)(7)(iii)(A) of this section transferred with the real property does not exceed 15 percent of the aggregate fair market value of the replacement real property or properties received in the exchange.

(8) *Examples*. This paragraph (g) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B is to transfer real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. The replacement property is identified as provided in paragraph (c) of this section (relating to identification of replacement property) and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

(i) *Example 1*.(A) On May 17, 1991, B transfers real property X to C. On the same day, C pays $10,000 to B and deposits $90,000 in escrow as security for C's obligation to perform under the agreement. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow before November 14, 1991, except that:

(*1*) if B fails to identify replacement property on or before July 1, 1991, B may demand the funds in escrow at any time after July 1, 1991; and

(*2*) if B identifies and receives replacement property, then B may demand the balance of the remaining funds in escrow at any time after B has received the replacement property.

(*3*) The funds in escrow may be used to purchase the replacement property. The escrow holder is not a disqualified person as defined in paragraph (k) of this section. Pursuant to the terms of the agreement, B identifies replacement property, and C purchases the replacement property using the funds in escrow and tranfers the replacement property to B.

(B) C's obligation to transfer the replacement property to B was secured by cash held in a qualified escrow account because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow as provided in paragraph (g)(6) of this section. In addition, B did not have the immediate ability or unrestricted right to receive money or other property in escrow before B actually received the like-kind replacement property. Therefore, for purposes of section 1031 and this section, B is determined not to be in actual or constructive receipt of the $90,000 held in escrow before B received the like-kind replacement property. The transfer of real property X by B and B's acquisition of the replacement property qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

(ii) *Example 2*. (A) On May 17, 1991, B transfers real property X to C, and C deposits $100,000 in escrow as security for C's obligation to perform under the agreement. Also on May 17, B identifies

real property J as replacement property. The escrow agreement provides that no funds may be paid out without prior written approval of both B and C. The escrow agreement also provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow before November 14, 1991, except that:

(*1*) B may demand the funds in escrow at any time after the later of July 1, 1991, and the occurrence of any of the following events—

(*i*) real property J is destroyed, seized, requisitioned, or condemned, or

(*ii*) a determination is made that the regulatory approval necessary for the transfer of real property J cannot be obtained in time for real property J to be transferred to B before the end of the exchange period;

(*2*) B may demand the funds in escrow at any time after August 14, 1991, if real property J has not been rezoned from residential to commercial use by that date; and

(*3*) B may demand the funds in escrow at the time B receives real property J or any time thereafter.

(*4*) Otherwise, B is entitled to all funds in escrow after November 13, 1991. The funds in escrow may be used to purchase the replacement property. The escrow holder is not a disqualified person as described in paragraph (k) of this section. Real property J is not rezoned from residential to commercial use on or before August 14, 1991.

(B) C's obligation to transfer the replacement property to B was secured by cash held in a qualified escrow account because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow as provided in paragraph (g)(6) of this section. From May 17, 1991, until August 15, 1991, B did not have the immediate ability or unrestricted right to receive money or other property before B actually received the like-kind replacement property. Therefore, for purposes of section 1031 and this section, B is determined not to be in actual or constructive receipt of the $100,000 in escrow from May 17, 1991, until August 15, 1991. However, on August 15, 1991, B had the unrestricted right, upon notice, to draw upon the $100,000 held in escrow. Thus, the safe harbor ceased to apply and B was in constructive receipt of the funds held in escrow. Because B constructively received the full amount of the consideration ($100,000) before B actually received the like-kind replacement property, the transaction is treated as a sale and not as a deferred exchange. The result does not change even if B chose not to demand the funds in escrow and continued to attempt to have real property J rezoned and to receive the property on or before November 13, 1991.

(C) If real property J had been rezoned on or before August 14, 1991, and C had purchased real property J and transferred it to B on or before November 13, 1991, the transaction would have qualified for nonrecognition of gain or loss under section 1031(a).

(iii) *Example 3.* (A) On May 1, 1991, D offers to purchase real property X for $100,000. However, D is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. The exchange agreement between B and C provides that B is to execute and deliver a deed conveying real property X to C who, in turn, is to execute and deliver a deed conveying real property X to D. The exchange agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. On May 3, 1991, C enters into an agreement with D to transfer real property X to D for $100,000. On May 17, 1991, B executes and delivers to C a deed conveying real property X to C. On the same date, C executes and delivers to D a deed conveying real property X to D, and D deposits $100,000 in escrow. The escrow holder is not a disqualified person as defined in paragraph (k) of this section and the escrow agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section. However, the escrow

agreement provides that the money in escrow may be used to purchase replacement property. On June 3, 1991, B identifies real property K as replacement property. On August 9, 1991, E executes and delivers to C a deed conveying real property K to C and $80,000 is released from the escrow and paid to E. On the same date, C executes and delivers to B a deed conveying real property K to B, and the escrow holder pays B $20,000, the balance of the $100,000 sale price of real property X remaining after the purchase of real property K for $80,000.

(B) B and C entered into an exchange agreement that satisfied the requirements of paragraph (g)(4)(iii)(B) of this section. Regardless of whether C may have acquired and transferred real property X under general tax principles, C is treated as having acquired and transferred real property X because C acquired and transferred legal title to real property X. Similarly, C is treated as having acquired and transferred real property K because C acquired and transferred legal title to real property K. Thus, C was a qualified intermediary. This result is reached for purposes of this section regardless of whether C was B's agent under state law.

(C) Because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section, the escrow account was a qualified escrow account. For purposes of section 1031 and this section, therefore, B is determined not to be in actual or constructive receipt of the funds in escrow before B received real property K.

(D) The exchange agreement between B and C expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of any money held by C as provided in paragraph (g)(6) of this section. Because C was a qualified intermediary, for purposes of section 1031 and this section B is determined not to be in actual or constructive receipt of any funds held by C before B received real property K. In addition, B's transfer of real property X and acquisition of real property K qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

(E) If the escrow agreement had expressly limited C's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section, but had not expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of that money or other property, the escrow account would not have been a qualified escrow account. Consequently, paragraph (g)(3)(i) of this section would not have been applicable in determining whether B was in actual or constructive receipt of that money or other property before B received real property K.

(iv) *Example 4.* (A) On May 1, 1991, B enters into an agreement to sell real property X to D for $100,000 on May 17, 1991. However, D is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. In the exchange agreement between B and C, B assigns to C all of B's rights in the agreement with D. The exchange agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. On May 17, 1991, B notifies D in writing of the assignment. On the same date, B executes and delivers to D a deed conveying real property X to D. D pays $10,000 to B and $90,000 to C. On June 1, 1991, B identifies real property L as replacement property. On July 5, 1991, B enters into an agreement to purchase real property L from E for $90,000, assigns its rights in that agreement to C, and notifies E in writing of the assignment. On August 9, 1991, C pays $90,000 to E, and E executes and delivers to B a deed conveying real property L to B.

(B) The exchange agreement entered into by B and C satisfied the requirements of paragraph (g)(4)(iii)(B) of this section. Because B's rights in its agreements with D and E were assigned to C,

and D and E were notified in writing of the assignment on or before the transfer of real properties X and L, respectively, C is treated as entering into those agreements. Because C is treated as entering into an agreement with D for the transfer of real property X and, pursuant to that agreement, real property X was transferred to D, C is treated as acquiring and transferring real property X. Similarly, because C is treated as entering into an agreement with E for the transfer of real property K and, pursuant to that agreement, real property K was transferred to B, C is treated as acquiring and transferring real property K. This result is reached for purposes of this section regardless of whether C was B's agent under state law and regardless of whether C is considered, under general tax principles, to have acquired title or beneficial ownership of the properties. Thus, C was a qualified intermediary.

(C) The exchange agreement between B and C expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by C as provided in paragraph (g)(6) of this section. Thus, B did not have the immediate ability or unrestricted right to receive money or other property held by C before B received real property L. For purposes of section 1031 and this section, therefore, B is determined not to be in actual or constructive receipt of the $90,000 held by C before B received real property L. In addition, the transfer of real property X by B and B's acquisition of real property L qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

(v) *Example 5.* (A) On May 1, 1991, B enters into an agreement to sell real property X to D for $100,000. However, D is unwilling to participate in a like-kind exchange. B thus enters into an agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. The agreement between B and C expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. C neither enters into an agreement with D to transfer real property X to D nor is assigned B's rights in B's agreement to sell real property X to D. On May 17, 1991, B transfers real property X to D and instructs D to transfer the $100,000 to C. On June 1, 1991, B identifies real property M as replacement property. On August 9, 1991, C purchases real property L from E for $100,000, and E executes and delivers to C a deed conveying real property M to C. On the same date, C executes and delivers to B a deed conveying real property M to B.

(B) Because B transferred real property X directly to D under B's agreement with D, C did not acquire real property X from B and transfer real property X to D. Moreover, because C did not acquire legal title to real property X, did not enter into an agreement with D to transfer real property X to D, and was not assigned B's rights in B's agreement to sell real property X to D, C is not treated as acquiring and transferring real property X. Thus, C was not a qualified intermediary and paragraph (g)(4))(i) of this section does not apply.

(C) B did not exchange real property X for real property M. Rather, B sold real property X to D and purchased, through C, real property M. Therefore, the transfer of real property X does not qualify for nonrecognition of gain or loss under section 1031.

(vi) *Example 6.* (A) In 2020, B transfers to C real property with a fair market value of $1,100,000 and an adjusted basis of $400,000. B's replacement property is an office building and, as a part of the exchange, B also will acquire certain office furniture in the building that is not real property, which is industry practice in a transaction of this type. The fair market value of the real property B will acquire is $1,000,000 and the fair market value of the personal property is $100,000.

(B) In a standard commercial transaction, the buyer of an office building typically also acquires some or all of the office furniture in the building. The fair market value of the personal property B will acquire does not exceed 15 percent of the fair market value of the office building B will acquire. Accordingly, under paragraph (g)(7)(iii) of this

section, the personal property is incidental to the real property in the exchange and is disregarded in determining whether the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of money or nonlike-kind property are expressly limited as provided in paragraph (g)(6) of this section. Upon the receipt of the personal property, B recognizes gain of $100,000 under section 1031(b), the lesser of the realized gain on the disposition of the relinquished property, $700,000, and the fair market value of the nonlike-kind property B acquired in the exchange, $100,000.

(9) *Applicability date.* Paragraphs (g)(7)(iii) and (g)(8)(vi) of this section apply to exchanges beginning after December 2, 2020.

(h) *Interest and growth factors*—(1) *In general.* For purposes of this section, the taxpayer is treated as being entitled to receive interest or a growth factor with respect to a deferred exchange if the amount of money or property the taxpayer is entitled to receive depends upon the length of time elapsed between transfer of the relinquished property and receipt of the replacement property.

(2) *Treatment as interest.* If, as part of a deferred exchange, the taxpayer receives interest or a growth factor, the interest or growth factor will be treated as interest, regardless of whether it is paid to the taxpayer in cash or in property (including property of a like kind). The taxpayer must include the interest or growth factor in income according to the taxpayer's method of accounting. For rules under section 468B(g) relating to the current taxation of qualified escrow accounts, qualified trusts, and other escrow accounts, trusts, and funds used during deferred exchanges of like-kind property, see § 1.468B–6.

(i) [Reserved]

(j) *Determination of gain or loss recognized and the basis of property received in a deferred exchange*—(1) *In general.* Except as otherwise provided, the amount of gain or loss recognized and the basis of property received in a deferred exchange is determined by applying the rules of section 1031 and the regulations thereunder. See §§ 1.1031(b)–1, 1.1031(c)–1, 1.1031(d)–1, 1.1031(d)–1T, 1.1031(d)–2, and 1.1031(j)–1.

(2) *Coordination with section 453*—(i) *Qualified escrow accounts and qualified trusts.* Subject to the limitations of paragraphs (j)(2) (iv) and (v) of this section, in the case of a taxpayer's transfer of relinquished property in which the obligation of the taxpayer's transferee to transfer replacement property to the taxpayer is or may be secured by cash or a cash equivalent, the determination of whether the taxpayer has received a payment for purposes of section 453 and § 15a.453–1(b)(3)(i) of this chapter will be made without regard to the fact that the obligation is or may be so secured if the cash or cash equivalent is held in a qualified escrow account or a qualified trust. This paragraph (j)(2)(i) ceases to apply at the earlier of—

(A) The time described in paragraph (g)(3)(iv) of this section; or

(B) The end of the exchange period.

(ii) *Qualified intermediaries.* Subject to the limitations of paragraphs (j)(2) (iv) and (v) of this section, in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the determination of whether the taxpayer has received a payment for purposes of section 453 and § 15a.453–1(b)(3)(i) of this chapter is made as if the qualified intermediary is not the agent of the taxpayer. For purposes of this paragraph (j)(2)(ii), a person who otherwise satisfies the definition of a qualified intermediary is treated as a qualified intermediary even though that person ultimately fails to acquire identified replacement property and transfer it to the taxpayer. This paragraph (j)(2)(ii) ceases to apply at the earlier of—

(A) The time described in paragraph (g)(4)(vi) of this section; or

(B) The end of the exchange period.

(iii) *Transferee indebtedness.* In the case of a transaction described in paragraph (j)(2)(ii) of this section, the receipt by the taxpayer of an evidence of indebtedness of the transferee of the qualified intermediary is treated as the receipt of an evidence of indebtedness of the person acquiring property from the taxpayer for purposes of section 453 and § 15a.453–1(b)(3)(i) of this chapter.

(iv) *Bona fide intent requirement.* The provisions of paragraphs (j)(2) (i) and (ii) of this section do not apply unless the taxpayer has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period. A taxpayer will be treated as having a bona fide intent only if it is reasonable to believe, based on all the facts and circumstances as of the beginning of the exchange period, that like-kind replacement property will be acquired before the end of the exchange period.

(v) *Disqualified property.* The provisions of paragraphs (j)(2) (i) and (ii) of this section do not apply if the relinquished property is disqualified property. For purposes of this paragraph (j)(2), *disqualified property* means property that is not held for productive use in a trade or business or for investment or is property described in section 1031(a)(2).

(vi) *Examples.* This paragraph (j)(2) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B is a calendar year taxpayer who agrees to enter into a deferred exchange. Pursuant to the agreement, B is to transfer real property X. Real property X, which has been held by B for investment, is unencumbered and has a fair market value of $100,000 at the time of transfer. B's adjusted basis in real property X at that time is $60,000. B identifies a single like-kind replacement property before the end of the identification period, and B receives the replacement property before the end of the exchange period. The transaction qualifies as a like-kind exchange under section 1031.

Example 1. (i) On September 22, 1994, B transfers real property X to C and C agrees to acquire like-kind property and deliver it to B. On that date B has a bona fide intent to enter into a deferred exchange. C's obligation, which is not payable on demand or readily tradable, is secured by $100,000 in cash. The $100,000 is deposited by C in an escrow account that is a qualified escrow account under paragraph (g)(3) of this section. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash deposited in the escrow account until the earlier of the date the replacement property is delivered to B or the end of the exchange period. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers the replacement property to B. The $20,000 in cash remaining in the qualified escrow account is distributed to B at that time.

(ii) Under section 1031(b), B recognizes gain to the extent of the $20,000 in cash that B receives in the exchange. Under paragraph (j)(2)(i) of this section, the qualified escrow account is disregarded for purposes of section 453 and §15a.453–1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B's receipt of C's obligation on September 22, 1994, does not constitute a payment. Instead, B is treated as receiving payment on March 11, 1995, on receipt of the $20,000 in cash from the qualified escrow account. Subject to the other requirements of sections 453 and 453A, B may report the $20,000 gain in 1995 under the installment method. See section 453(f)(6) for special rules for determining total contract price and gross profit in the case of an exchange described in section 1031(b).

Example 2. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. On September 22, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for $100,000 in cash. On that date B has a bona fide intent to enter into a deferred exchange. C is a qualified intermediary under paragraph (g)(4) of this section. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by C until the earlier of the date the replacement property is delivered to B or the end of the exchange period. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers it, along with the remaining $20,000 from the transfer of real property X to B.

(ii) Under section 1031(b), B recognizes gain to the extent of the $20,000 cash B receives in the exchange. Under paragraph (j)(2)(ii) of this section, any agency relationship between B and C is disregarded for purposes of section 453 and §15a.453–1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on September 22, 1994, on C's receipt of payment from D for the relinquished property. Instead, B is treated as receiving payment on March 11, 1995, on receipt of the $20,000 in cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $20,000 gain in 1995 under the installment method.

Example 3. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an

exchange with respect to real property X. On December 1, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for $100,000 in cash. On that date B has a bona fide intent to enter into a deferred exchange. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by C until the earliest of the end of the identification period if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. Although B has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period, B does not identify or acquire any replacement property. In 1995, at the end of the identification period, C delivers the entire $100,000 from the sale of real property X to B.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis in real property X ($60,000), or $40,000. Because B has a bona fide intent at the beginning of the exchange period to enter into a deferred exchange, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary even though C does not acquire and transfer replacement property to B. Thus, any agency relationship between B and C is disregarded for purposes of section 453 and § 15a.453–1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on December 1, 1994, on C's receipt of payment from D for the relinquished property. Instead, B is treated as receiving payment at the end of the identification period in 1995 on receipt of the $100,000 in cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

Example 4. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is a qualified intermediary under paragraph (g)(4) of this section. On September 22, 1994, pursuant to the agreement, B transfers real property X to C who then transfers it to D for $80,000 in cash and D's 10-year installment obligation for $20,000. On that date B has a bona fide intent to enter into a deferred exchange. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property held by C until the earlier of the date the replacement property is delivered to B or the end of the exchange period. D's obligation bears adequate stated interest and is not payable on demand or readily tradable. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers it, along with the $20,000 installment obligation, to B.

(ii) Under section 1031(b), $20,000 of B's gain (i.e., the amount of the installment obligation B receives in the exchange) does not qualify for nonrecognition under section 1031(a). Under paragraphs (j)(2) (ii) and (iii) of this section, B's receipt of D's obligation is treated as the receipt of an obligation of the person acquiring the property for purposes of section 453 and § 15a.453–1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B's receipt of the obligation is not treated as a payment. Subject to the other requirements of sections 453 and 453A, B may report the $20,000 gain under the installment method on receiving payments from D on the obligation.

Example 5. (i) B is a corporation that has held real property X to expand its manufacturing operations. However, at a meeting in November 1994, B's directors decide that real property X is not suitable for the planned expansion, and authorize a like-kind exchange of this property for property that would be suitable for the planned expansion. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an exchange with respect to real property X. On November 28, 1994, pursuant to the agreement, B transfers real property X to C, who then transfers it to D for $100,000 in cash. The exchange agreement does not include any limitations or conditions that make it unreasonable to believe that like-kind replacement property will be acquired before the end of the exchange period. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by C until the earliest of the end of the identification period, if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. In early January 1995, B's directors meet and decide that it is not feasible to proceed with the planned expansion due to a business downturn reflected in B's preliminary financial reports for the last quarter of 1994. Thus, B's directors instruct C to stop seeking replacement property. C delivers the $100,000 cash to B on January 12, 1995, at the end of the identification period. Both the decision to exchange real property X for other property and the decision to cease seeking replacement property because of B's business downturn are recorded in the minutes of the directors' meetings. There are no other facts or circumstances that would indicate whether, on November 28, 1994, B had a bona fide intent to enter into a deferred like-kind exchange.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis of real property X ($60,000), or $40,000. The directors' authorization of a like-kind exchange, the terms of the exchange agreement with C, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred like-kind exchange. Thus, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable, even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary, even though C does not transfer replacement property to B. Thus, any agency relationship between B and C is disregarded for purposes of section 453 and §15a.453–1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment until January 12, 1995, on receipt of the $100,000 cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

Example 6. (i) B has held real property X for use in its trade or business, but decides to transfer that property because it is no longer suitable for B's planned expansion of its commercial enterprise. B and D agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to D on September 22, 1994, and D deposits $100,000 cash in a qualified escrow account as security for D's obligation under the agreement to transfer replacement property to B before the end of the exchange period. D's obligation is not payable on demand or readily tradable. The agreement provides that B is not required to accept any property that is not zoned for commercial use. Before the end of the identification period, B identifies real properties J, K, and L, all zoned for residential use, as replacement properties. Any one of these properties, rezoned for commercial use, would be suitable for B's planned expansion. In recent years, the zoning board with jurisdiction over properties J, K, and L has rezoned similar properties for commercial use. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in the escrow account until the earlier of the time that the zoning board determines, after the end of the identification period, that it will not rezone the properties for commercial use or the end of the exchange period. On January 5, 1995, the zoning board decides that none of the properties will be rezoned for commercial use. Pursuant to the exchange agreement, B receives the $100,000 cash from the escrow on January 5, 1995. There are no other facts or circumstances that would indicate whether, on September 22, 1994, B had a bona fide intent to enter into a deferred like-kind exchange.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis of real property X ($60,000), or $40,000. The terms of the exchange agreement with D, the identification of properties J, K, and L, the efforts to have those properties rezoned for commercial purposes, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred exchange. Moreover, the limitations imposed in the exchange agreement on acceptable replacement property do not make it unreasonable to believe that like-kind replacement property would be acquired before the end of the exchange period. Therefore, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(i) of this section inapplicable even though B fails to acquire replacement property. Thus, for purposes of section 453 and §15a.453–1(b)(3)(i) of this chapter, the qualified escrow account is disregarded in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on September 22, 1994, on D's deposit of the $100,000 cash into the qualified escrow account. Instead, B is treated as receiving payment on January 5, 1995. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

(vii) *Effective date*. This paragraph (j)(2) is effective for transfers of property occurring on or after April 20, 1994. Taxpayers may apply this paragraph (j)(2) to transfers of property occurring before April 20, 1994, but on or after June 10, 1991, if those transfers otherwise meet the requirements of §1.1031(k)–1. In addition, taxpayers may apply this paragraph (j)(2) to transfers of property occurring before June 10, 1991, but on or after May 16, 1990, if those transfers otherwise meet the requirements of §1.1031(k)–1 or follow the guidance of IA–237–84 published in 1990–1, C.B. See §601.601(d)(2)(ii)(*b*) of this chapter.

(3) *Examples*. This paragraph (j) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B is to transfer real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. B's

adjusted basis in real property X is $40,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received. The replacement property is identified as provided in paragraph (c) of this section and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

Example 1. (i) On May 17, 1991, B transfers real property X to C and identifies real property R as replacement property. On June 3, 1991, C transfers $10,000 to B. On September 4, 1991, C purchases real property R for $90,000 and transfers real property R to B.

(ii) The $10,000 received by B is ''money or other property'' for purposes of section 1031 and the regulations thereunder. Under section 1031(b), B recognizes gain in the amount of $10,000. Under section 1031(d), B's basis in real property R is $40,000 (i.e., B's basis in real property X ($40,000), decreased in the amount of money received ($10,000), and increased in the amount of gain recognized ($10,000) in the deferred exchange).

Example 2. (i) On May 17, 1991, B transfers real property X to C and identifies real property S as replacement property, and C transfers $10,000 to B. On September 4, 1991, C purchases real property S for $100,000 and transfers real property S to B. On the same day, B transfers $10,000 to C.

(ii) The $10,000 received by B is ''money or other property'' for purposes of section 1031 and the regulations thereunder. Under section 1031(b), B recognizes gain in the amount of $10,000. Under section 1031(d), B's basis in real property S is $50,000 (i.e., B's basis in real property X ($40,000), decreased in the amount of money received ($10,000), increased in the amount of gain recognized ($10,000), and increased in the amount of the additional consideration paid by B ($10,000) in the deferred exchange).

Example 3. (i) Under the exchange agreement, B has the right at all times to demand $100,000 in cash in lieu of replacement property. On May 17, 1991, B transfers real property X to C and identifies real property T as replacement property. On September 4, 1991, C purchases real property T for $100,000 and transfers real property T to B.

(ii) Because B has the right on May 17, 1991, to demand $100,000 in cash in lieu of replacement property, B is in constructive receipt of the $100,000 on that date. Thus, the transaction is a sale and not an exchange, and the $60,000 gain realized by B in the transaction (i.e., $100,000 amount realized less $40,000 adjusted basis) is recognized. Under section 1031(d), B's basis in real property T is $100,000.

Example 4. (i) Under the exchange agreement, B has the right at all times to demand up to $30,000 in cash and the balance in replacement propertry instead of receiving replacement property in the amount of $100,000. On May 17, 1991, B transfers real property X to C and identifies real property U as replacement property. On September 4, 1991, C purchases real property U for $100,000 and transfers real property U to B.

(ii) The transaction qualifies as a deferred exchange under section 1031 and this section. However, because B had the right on May 17, 1991, to demand up to $30,000 in cash, B is in constructive receipt of $30,000 on that date. Under section 1031(b), B recognizes gain in the amount of $30,000. Under section 1031(d), B's basis in real property U is $70,000 (i.e., B's basis in real property X ($40,000), decreased in the amount of money that B received ($30,000), increased in the amount of gain recognized ($30,000), and increased in the amount of additional consideration paid by B ($30,000) in the deferred exchange).

Example 5. (i) Assume real property X is encumbered by a mortgage of $30,000. On May 17, 1991, B transfers real property X to C and identifies real property V as replacement property, and C assumes the $30,000 mortgage on real property X. Real property V is encumbered by a $20,000 mortgage. On July 5, 1991, C purchases real property V for $90,000 by paying $70,000 and assuming the mortgage and transfers real property V to B with B assuming the mortgage.

(ii) The consideration received by B in the form of the liability assumed by C ($30,000) is offset by the consideration given by B in the form of the liability assumed by B ($20,000). The excess of the liability assumed by C over the liability assumed by B, $10,000, is treated as ''money or other property.'' See § 1.1031(b)–1(c). Thus, B recognizes gain under section 1031(b) in the amount of $10,000. Under section 1031(d), B's basis in real property V is $40,000 (i.e., B's basis in real property X ($40,000), decreased in the amount of money that B is treated as receiving in the form of the liability assumed by C ($30,000), increased in the amount of money that B is treated as paying in the form of the liability assumed by B ($20,000), and increased in the

amount of the gain recognized ($10,000) in the deferred exchange).

(k) *Definition of disqualified person.* (1) For purposes of this section, a disqualified person is a person described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

(2) The person is the agent of the taxpayer at the time of the transaction. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction. Solely for purposes of this paragraph (k)(2), performance of the following services will not be taken into account—

(i) Services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031; and

(ii) Routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.

(3) The person and the taxpayer bear a relationship described in either section 267(b) or section 707(b) (determined by substituting in each section ''10 percent'' for ''50 percent'' each place it appears).

(4)(i) Except as provided in paragraph (k)(4)(ii) of this section, the person and a person described in paragraph (k)(2) of this section bear a relationship described in either section 267(b) or 707(b) (determined by substituting in each section ''10 percent'' for ''50 percent'' each place it appears).

(ii) In the case of a transfer of relinquished property made by a taxpayer on or after January 17, 2001, paragraph (k)(4)(i) of this section does not apply to a bank (as defined in section 581) or a bank affiliate if, but for this paragraph (k)(4)(ii), the bank or bank affiliate would be a disqualified person under paragraph (k)(4)(i) of this section solely because it is a member of the same controlled group (as determined under section 267(f)(1), substituting ''10 percent'' for ''50 percent' where it appears) as a person that has provided investment banking or brokerage services to the taxpayer within the 2-year period described in paragraph (k)(2) of this section. For purposes of this paragraph (k)(4)(ii), a bank affiliate is a corporation whose principal activity is rendering services to facilitate exchanges of property intended to qualify for nonrecognition of gain under section 1031 and all of whose stock is owned by either a bank or a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a)).

(5) This paragraph (k) may be illustrated by the following examples. Unless otherwise provided, the following facts are assumed: On May 1, 1991, B enters into an exchange agreement (as defined in paragraph (g)(4)(iii)(B) of this section) with C whereby B retains C to facilitate an exchange with respect to real property X. On May 17, 1991, pursuant to the agreement, B executes and delivers to C a deed conveying real property X to C. C has no relationship to B described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

Example 1. (i) C is B's accountant and has rendered accounting services to B within the 2-year period ending on May 17, 1991, other than with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031.

(ii) C is a disqualified person because C has acted as B's accountant within the 2-year period ending on May 17, 1991.

(iii) If C had not acted as B's accountant within the 2-year period ending on May 17, 1991, or if C had acted as B's accountant within that period only with respect to exchanges intended to qualify for nonrecognition of gain or loss under section 1031, C would not have been a disqualified person.

Example 2. (i) C, which is engaged in the trade or business of acting as an intermediary to facilitate deferred exchanges, is a wholly owned subsidiary of an escrow company that has performed routine escrow services for B in the past. C has previously been retained by B to act as an intermediary in prior section 1031 exchanges.

(ii) C is not a disqualified person notwithstanding the intermediary services previously provided by C to B (see paragraph (k)(2)(i) of this section) and notwithstanding the combination of C's relationship to the escrow company and the escrow services previously provided by the escrow company to B (see paragraph (k)(2)(ii) of this section).

Example 3. (i) C is a corporation that is only engaged in the trade or business of acting as an intermediary to facilitate deferred

exchanges. Each of 10 law firms owns 10 percent of the outstanding stock of C. One of the 10 law firms that owns 10 percent of C is M. J is the managing partner of M and is the president of C. J, in his capacity as a partner in M, has also rendered legal advice to B within the 2-year period ending on May 17, 1991, on matters other than exchanges intended to qualify for nonrecognition of gain or loss under section 1031.

(ii) J and M are disqualified persons. C, however, is not a disqualified person because neither J nor M own, directly or indirectly, more than 10 percent of the stock of C. Similarly, J's participation in the management of C does not make C a disqualified person.

(l) [Reserved]

(m) *Definition of fair market value.* For purposes of this section, the fair market value of property means the fair market value of the property without regard to any liabilities secured by the property.

(n) *No inference with respect to actual or constructive receipt rules outside of section 1031.* The rules provided in this section relating to actual or constructive receipt are intended to be rules for determining whether there is actual or constructive receipt in the case of a deferred exchange. No inference is intended regarding the application of these rules for purposes of determining whether actual or constructive receipt exists for any other purpose.

(o) *Effective date.* This section applies to transfers of property made by a taxpayer on or after June 10, 1991. However, a transfer of property made by a taxpayer on or after May 16, 1990, but before June 10, 1991, will be treated as complying with section 1031 (a)(3) and this section if the deferred exchange satisfies either the provision of this section or the provisions of the notice of proposed rulemaking published in the FEDERAL REGISTER on May 16, 1990 (55 FR 20278).

[T.D. 8346, 56 FR 19938, May 1, 1991, as amended by T.D. 8535, 59 FR 18749, Apr. 20, 1994; T.D. 8982, 67 FR 4909, Feb. 1, 2002; T.D. 9413, 73 FR 39622, July 10, 2008; T.D. 9935, 85 FR 77383, Dec. 2, 2020]

§ 1.1032–1 Disposition by a corporation of its own capital stock.

(a) The disposition by a corporation of shares of its own stock (including treasury stock) for money or other property does not give rise to taxable gain or deductible loss to the corporation regardless of the nature of the transaction or the facts and circumstances involved. For example, the receipt by a corporation of the subscription price of shares of its stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be equal to, in excess of, or less than, the par or stated value of such stock. Also, the exchange or sale by a corporation of its own shares for money or other property does not result in taxable gain or deductible loss, even though the corporation deals in such shares as it might in the shares of another corporation. A transfer by a corporation of shares of its own stock (including treasury stock) as compensation for services is considered, for purposes of section 1032(a), as a disposition by the corporation of such shares for money or other property.

(b) Section 1032(a) does not apply to the acquisition by a corporation of shares of its own stock except where the corporation acquires such shares in exchange for shares of its own stock (including treasury stock). See paragraph (e) of § 1.311–1, relating to treatment of acquisitions of a corporation's own stock. Section 1032(a) also does not relate to the tax treatment of the recipient of a corporation's stock.

(c) Where a corporation acquires shares of its own stock in exchange for shares of its own stock (including treasury stock) the transaction may qualify not only under section 1032(a), but also under section 368(a)(1)(E) (recapitalization) or section 305(a) (distribution of stock and stock rights).

(d) For basis of property acquired by a corporation in connection with a transaction to which section 351 applies or in connection with a reorganization, see section 362. For basis of property acquired by a corporation in a transaction to which section 1032 applies but which does not qualify under any other nonrecognition provision, see section 1012.

§ 1.1032–2 Disposition by a corporation of stock of a controlling corporation in certain triangular reorganizations.

(a) *Scope.* This section provides rules for certain triangular reorganizations

described in §1.358–6(b) when the acquiring corporation (*S*) acquires property or stock of another corporation (*T*) in exchange for stock of the corporation (*P*) in control of *S*.

(b) *General nonrecognition of gain or loss.* For purposes of §1.1032–1(a), in the case of a forward triangular merger, a triangular C reorganization, or a triangular B reorganization (as described in §1.358–6(b)), *P* stock provided by *P* to *S*, or directly to *T* or *T*'s shareholders on behalf of *S*, pursuant to the plan of reorganization is treated as a disposition by *P* of shares of its own stock for *T*'s assets or stock, as applicable. For rules governing the use of *P* stock in a reverse triangular merger, see section 361.

(c) *Treatment of S. S* must recognize gain or loss on its exchange of *P* stock as consideration in a forward triangular merger, a triangular C reorganization, or a triangular B reorganization (as described in §1.358–6(b)), if *S* did not receive the *P* stock from *P* pursuant to the plan of reorganization. See §1.358–6(d) for the effect on *P*'s basis in its *S* or *T* stock, as applicable. For rules governing *S*'s use of *P* stock in a reverse triangular merger, see section 361.

(d) *Examples.* The rules of this section are illustrated by the following examples. For purposes of these examples, *P*, *S*, and *T* are domestic corporations, *P* and *S* do not file consolidated returns, *P* owns all of the only class of *S* stock, the *P* stock exchanged in the transaction satisfies the requirements of the applicable reorganization provisions, and the facts set forth the only corporate activity.

Example 1. Forward triangular merger solely for P stock. (a) *Facts. T* has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. Pursuant to a plan, *P* forms *S* by transferring $100 of *P* stock to *S* and *T* merges into *S*. In the merger, the *T* shareholders receive, in exchange for their *T* stock, the *P* stock that *P* transferred to *S*. The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(D) apply.

(b) *No gain or loss recognized on the use of P stock.* Under paragraph (b) of this section, the *P* stock provided by *P* pursuant to the plan of reorganization is treated for purposes of §1.1032–1(a) as disposed of by *P* for the *T* assets acquired by *S* in the merger. Consequently, neither *P* nor *S* has taxable gain or deductible loss on the exchange.

Example 2. Forward triangular merger solely for P stock provided in part by S. (a) *Facts. T* has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. *S* is an operating company with substantial assets that has been in existence for several years. *S* also owns *P* stock with a $20 adjusted basis and $30 fair market value. *S* acquired the *P* stock in an unrelated transaction several years before the reorganization. Pursuant to a plan, *P* transfers additional *P* stock worth $70 to *S* and *T* merges into *S*. In the merger, the *T* shareholders receive $100 of *P* stock ($70 of *P* stock provided by *P* to *S* as part of the plan and $30 of *P* stock held by *S* previously). The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(D) apply.

(b) *Gain or loss recognized by S on the use of its P* stock. Under paragraph (b) of this section, the $70 of *P* stock provided by *P* pursuant to the plan of reorganization is treated as disposed of by *P* for the *T* assets acquired by *S* in the merger. Consequently, neither *P* nor *S* has taxable gain or deductible loss on the exchange of those shares. Under paragraph (c) of this section, however, *S* recognizes $10 of gain on the exchange of its *P* stock in the reorganization because *S* did not receive the *P* stock from *P* pursuant to the plan of reorganization. See §1.358–6(d) for the effect on *P*'s basis in its *S* stock.

(e) *Stock options.* The rules of this section shall apply to an option to buy or sell P stock issued by P in the same manner as the rules of this section apply to P stock.

(f) *Effective dates.* This section applies to triangular reorganizations occurring on or after December 23, 1994, except for paragraph (e) of this section, which applies to transfers of stock options occurring on or after May 16, 2000.

[T.D. 8648, 60 FR 66081, Dec. 21, 1995, as amended by T.D. 8883, 65 FR 31076, May 16, 2000]

§ 1.1032–3 Disposition of stock or stock options in certain transactions not qualifying under any other nonrecognition provision.

(a) *Scope.* This section provides rules for certain transactions in which a corporation or a partnership (the acquiring entity) acquires money or other property (as defined in §1.1032–1) in exchange, in whole or in part, for stock of a corporation (the issuing corporation).

(b) *Nonrecognition of gain or loss*—(1) *General rule.* In a transaction to which this section applies, no gain or loss is recognized on the disposition of the

issuing corporation's stock by the acquiring entity. The transaction is treated as if, immediately before the acquiring entity disposes of the stock of the issuing corporation, the acquiring entity purchased the issuing corporation's stock from the issuing corporation for fair market value with cash contributed to the acquiring entity by the issuing corporation (or, if necessary, through intermediate corporations or partnerships). For rules that may apply in determining the issuing corporation's adjustment to basis in the acquiring entity (or, if necessary, in determining the adjustment to basis in intermediate entities), see sections 358, 722, and the regulations thereunder.

(2) *Special rule for actual payment for stock of the issuing corporation*. If the issuing corporation receives money or other property in payment for its stock, the amount of cash deemed contributed under paragraph (b)(1) of this section is the difference between the fair market value of the issuing corporation stock and the amount of money or the fair market value of other property that the issuing corporation receives as payment.

(c) *Applicability*. The rules of this section apply only if, pursuant to a plan to acquire money or other property—

(1) The acquiring entity acquires stock of the issuing corporation directly or indirectly from the issuing corporation in a transaction in which, but for this section, the basis of the stock of the issuing corporation in the hands of the acquiring entity would be determined, in whole or in part, with respect to the issuing corporation's basis in the issuing corporation's stock under section 362(a) or 723 (provided that, in the case of an indirect acquisition by the acquiring entity, the transfers of issuing corporation stock through intermediate entities occur immediately after one another);

(2) The acquiring entity immediately transfers the stock of the issuing corporation to acquire money or other property (from a person other than an entity from which the stock was directly or indirectly acquired);

(3) The party receiving stock of the issuing corporation in the exchange specified in paragraph (c)(2) of this section from the acquiring entity does not receive a substituted basis in the stock of the issuing corporation within the meaning of section 7701(a)(42); and

(4) The issuing corporation stock is not exchanged for stock of the issuing corporation.

(d) *Stock options*. The rules of this section shall apply to an option issued by a corporation to buy or sell its own stock in the same manner as the rules of this section apply to the stock of an issuing corporation.

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

Example 1. (i) *X*, a corporation, owns all of the stock of *Y* corporation. *Y* reaches an agreement with *C*, an individual, to acquire a truck from *C* in exchange for 10 shares of *X* stock with a fair market value of $100. To effectuate *Y*'s agreement with *C*,*X* transfers to *Y* the *X* stock in a transaction in which, but for this section, the basis of the *X* stock in the hands of *Y* would be determined with respect to *X*'s basis in the *X* stock under section 362(a). *Y* immediately transfers the *X* stock to *C* to acquire the truck.

(ii) In this *Example 1*, no gain or loss is recognized on the disposition of the *X* stock by *Y*. Immediately before *Y*'s disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for $100 of cash contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by $100.

Example 2. (i) Assume the same facts as *Example 1*, except that, rather than *X* stock, *X* transfers an option with a fair market value of $100 to purchase *X* stock.

(ii) In this *Example 2*, no gain or loss is recognized on the disposition of the *X* stock option by *Y*. Immediately before *Y*'s disposition of the *X* stock option, *Y* is treated as purchasing the *X* stock option from *X* for $100 of cash contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by $100.

Example 3. (i) *X*, a corporation, owns all of the outstanding stock of *Y* corporation. *Y* is a partner in partnership *Z*. *Z* reaches an agreement with *C*, an individual, to acquire a truck from *C* in exchange for 10 shares of *X* stock with a fair market value of $100. To effectuate *Z*'s agreement with *C*, *X* transfers to *Y* the *X* stock in a transaction in which, but for this section, the basis of the *X* stock in the hands of *Y* would be determined with respect to *X*'s basis in the *X* stock under section 362(a). *Y* immediately transfers the *X* stock to *Z* in a transaction in which, but for this section, the basis of the *X* stock in the hands of *Z* would be determined under section 723. *Z* immediately transfers the *X* stock to *C* to acquire the truck.

(ii) In this *Example 3*, no gain or loss is recognized on the disposition of the *X* stock by *Z*. Immediately before *Z*'s disposition of the *X* stock, *Z* is treated as purchasing the *X* stock from *X* for $100 of cash indirectly contributed to *Z* by *X* through an intermediate corporation, *Y*. Under section 722, *Y*'s basis in its *Z* partnership interest is increased by $100, and, under section 358, *X*'s basis in its *Y* stock is increased by $100.

Example 4. (i) *X*, a corporation, owns all of the outstanding stock of *Y* corporation. *B*, an individual, is an employee of *Y*. Pursuant to an agreement between *X* and *Y* to compensate *B* for services provided to *Y*, *X* transfers to *B* 10 shares of *X* stock with a fair market value of $100. Under §1.83-6(d), but for this section, the transfer of *X* stock by *X* to *B* would be treated as a contribution of the *X* stock by *X* to the capital of *Y*, and immediately thereafter, a transfer of the *X* stock by *Y* to *B*. But for this section, the basis of the *X* stock in the hands of *Y* would be determined with respect to *X*'s basis in the *X* stock under section 362(a).

(ii) In this *Example 4*, no gain or loss is recognized on the deemed disposition of the *X* stock by *Y*. Immediately before *Y*'s deemed disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for $100 of cash contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by $100.

Example 5. (i) *X*, a corporation, owns all of the outstanding stock of *Y* corporation. *B*, an individual, is an employee of *Y*. To compensate *B* for services provided to *Y*, *B* is offered the opportunity to purchase 10 shares of *X* stock with a fair market value of $100 at a reduced price of $80. *B* transfers $80 and *Y* transfers $10 to *X* as partial payment for the *X* stock.

(ii) In this *Example 5*, no gain or loss is recognized on the deemed disposition of the *X* stock by *Y*. Immediately before *Y*'s deemed disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for $100, $80 of which *Y* is deemed to have received from *B*, $10 of which originated with *Y*, and $10 of which is deemed to have been contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by $10.

Example 6. (i) *X*, a corporation, owns stock of *Y*. To compensate *Y*'s employee, *B*, for services provided to *Y*, *X* issues 10 shares of *X* stock to *B*, subject to a substantial risk of forfeiture. *B* does not have an election under section 83(b) in effect with respect to the *X* stock. *X* retains the only reversionary interest in the *X* stock in the event that *B* forfeits the right to the stock. Several years after *X*'s transfer of the *X* shares, the stock vests. At the time the stock vests, the 10 shares of *X* stock have a fair market value of $100. Under §1.83-6(d), but for this section, the transfer of the *X* stock by *X* to *B* would be treated, at the time the stock vests, as a contribution of the *X* stock by *X* to the capital of *Y*, and immediately thereafter, a disposition of the *X* stock by *Y* to *B*. The basis of the *X* stock in the hands of *Y*, but for this section, would be determined with respect to *X*'s basis in the *X* stock under section 362(a).

(ii) In this *Example 6*, no gain or loss is recognized on the deemed disposition of *X* stock by *Y* when the stock vests. Immediately before *Y*'s deemed disposition of the *X* stock, *Y* is treated as purchasing *X*'s stock from *X* for $100 of cash contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by $100.

Example 7. (i) Assume the same facts as in *Example 6*, except that *Y* (rather than *X*) retains a reversionary interest in the *X* stock in the event that *B* forfeits the right to the stock. Several years after *X*'s transfer of the *X* shares, the stock vests.

(ii) In this *Example 7*, this section does not apply to *Y*'s deemed disposition of the *X* shares because *Y* is not deemed to have transferred the *X* stock to *B* immediately after receiving the stock from *X*. For the tax consequences to *Y* on the deemed disposition of the *X* stock, see §1.83–6(b).

Example 8. (i) *X*, a corporation, owns all of the outstanding stock of *Y* corporation. In Year 1, *X* issues to *Y*'s employee, *B*, a nonstatutory stock option to purchase 10 shares of *X* stock as compensation for services provided to *Y*. The option is exercisable against *X* and does not have a readily ascertainable fair market value (determined under §1.83–7(b)) at the time the option is granted. In Year 2, *B* exercises the option by paying *X* the strike price of $80 for the *X* stock, which then has a fair market value of $100.

(ii) In this *Example 8*, because, under section 83(e)(3), section 83(a) does not apply to the grant of the option, paragraph (d) of this section also does not apply to the grant of the option. Section 83 and §1.1032–3 apply in Year 2 when the option is exercised; thus, no gain or loss is recognized on the deemed disposition of *X* stock by *Y* in Year 2. Immediately before *Y*'s deemed disposition of the *X* stock in Year 2, *Y* is treated as purchasing the *X* stock from *X* for $100, $80 of which *Y* is deemed to have received from B and the remaining $20 of which is deemed to have been contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by $20.

Example 9. (i) *A*, an individual, owns a majority of the stock of *X*. *X* owns stock of *Y* constituting control of *Y* within the meaning of section 368(c). *A* transfers 10 shares of its *X* stock to B, a key employee of *Y*. The fair market value of the 10 shares on the date of transfer was $100.

(ii) In this *Example 9*, *A* is treated as making a nondeductible contribution of the 10 shares of *X* to the capital of *X*, and no gain or loss is recognized by *A* as a result of this transfer. See *Commissioner v. Fink*, 483 U.S. 89

(1987). *A* must allocate his basis in the transferred shares to his remaining shares of *X* stock. No gain or loss is recognized on the deemed disposition of the *X* stock by *Y*. Immediately before *Y*'s disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for $100 of cash contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by $100.

Example 10. (i) In Year 1, *X*, a corporation, forms a trust which will be used to satisfy deferred compensation obligations owed by *Y*, *X*'s wholly owned subsidiary, to *Y*'s employees. *X* funds the trust with *X* stock, which would revert to *X* upon termination of the trust, subject to the employees' rights to be paid the deferred compensation due to them. The creditors of *X* can reach all the trust assets upon the insolvency of *X*. Similarly, *Y*'s creditors can reach all the trust assets upon the insolvency of *Y*. In Year 5, the trust transfers *X* stock to the employees of *Y* in satisfaction of the deferred compensation obligation.

(ii) In this *Example 10*, *X* is considered to be the grantor of the trust, and, under section 677, *X* is also the owner of the trust. Any income earned by the trust would be reflected on *X*'s income tax return. *Y* is not considered a grantor or owner of the trust corpus at the time *X* transfers *X* stock to the trust. In Year 5, when employees of *Y* receive X stock in satisfaction of the deferred compensation obligation, no gain or loss is recognized on the deemed disposition of the *X* stock by *Y*. Immediately before *Y*'s deemed disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for fair market value using cash contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock increases by the amount of cash deemed contributed.

(f) *Effective date*. This section applies to transfers of stock or stock options of the issuing corporation occurring on or after May 16, 2000.

[T.D. 8883, 65 FR 31076, May 16, 2000; 65 FR 37482, June 15, 2000]

§ 1.1033(a)–1 Involuntary conversions; nonrecognition of gain.

(a) *In general*. Section 1033 applies to cases where property is compulsorily or involuntarily converted. An *involuntary conversion* may be the result of the destruction of property in whole or in part, the theft of property, the seizure of property, the requisition or condemnation of property, or the threat or imminence of requisition or condemnation of property. An *involuntary conversion* may be a conversion into similar property or into money or into dissimilar property. Section 1033 provides that, under certain specified circumstances, any gain which is realized from an involuntary conversion shall not be recognized. In cases where property is converted into other property similar or related in service or use to the converted property, no gain shall be recognized regardless of when the disposition of the converted property occurred and regardless of whether or not the taxpayer elects to have the gain not recognized. In other types of involuntary conversion cases, however, the proceeds arising from the disposition of the converted property must (within the time limits specified) be reinvested in similar property in order to avoid recognition of any gain realized. Section 1033 applies only with respect to gains; losses from involuntary conversions are recognized or not recognized without regard to this section.

(b) *Special rules*. For rules relating to the application of section 1033 to involuntary conversions of a principal residence with respect to which an election has been made under section 121 (relating to gain from sale or exchange of residence of individual who has attained age 65), see paragraph (g) of § 1.121–5. For rules applicable to involuntary conversions of a principal residence occurring before January 1, 1951, see § 1.1033(a)–3. For rules applicable to involuntary conversions of a principal residence occurring after December 31, 1950, and before January 1, 1954, see paragraph (h)(1) of § 1.1034–1. For rules applicable to involuntary conversions of a personal residence occurring after December 31, 1953, see § 1.1033(a)–3. For special rules relating to the election to have section 1034 apply to certain involuntary conversions of a principal reisdence occurring after December 31, 1957, see paragraph (h)(2) of § 1.1034–1. For special rules relating to certain involuntary conversions of real property held either for productive use in trade or business or for investment and occurring after December 31, 1957, see § 1.1033(g)–1. See also special rules applicable to involuntary conversions of property sold pursuant to reclamation laws, livestock destroyed by disease, and livestock sold on account of drought provided in §§ 1.1033(c)–1, 1.1033(d)–1, and 1.1033(e)–1, respectively. For rules relating to basis of property

acquired through involuntary conversions, see § 1.1033(b)–1. For determination of the period for which the taxpayer has held property acquired as a result of certain involuntary conversions, see section 1223 and regulations issued thereunder. For treatment of gains from involuntary conversions as capital gains in certain cases, see section 1231(a) and regulations issued thereunder. For portion of war loss recoveries treated as gain on involuntary conversion, see section 1332(b)(3) and regulations issued thereunder.

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6856, 30 FR 13318, Oct. 20, 1965; T.D. 7625, 44 FR 31013, May 30, 1979; T.D. 7758, 46 FR 6925, Jan. 22, 1981]

§ 1.1033(a)–2 Involuntary conversion into similar property, into money or into dissimilar property.

(a) *In general*. The term *disposition of the converted property* means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(b) *Conversion into similar property*. If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted only into property similar or related in service or use to the property so converted, no gain shall be recognized. Such nonrecognition of gain is mandatory.

(c) *Conversion into money or into dissimilar property*. (1) If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain, if any, shall be recognized, at the election of the taxpayer, only to the extent that the amount realized upon such conversion exceeds the cost of other property purchased by the taxpayer which is similar or related in service or use to the property so converted, or the cost of stock of a corporation owning such other property which is purchased by the taxpayer in the acquisition of control of such corporation, if the taxpayer purchased such other property, or such stock, for the purpose of replacing the property so converted and during the period specified in subparagraph (3) of this paragraph. For the purposes of section 1033, the term *control* means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

(2) All of the details in connection with an involuntary conversion of property at a gain (including those relating to the replacement of the converted property, or a decision not to replace, or the expiration of the period for replacement) shall be reported in the return for the taxable year or years in which any of such gain is realized. An election to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph shall be made by including such gain in gross income for such year or years only to such extent. If, at the time of filing such a return, the period within which the converted property must be replaced has expired, or if such an election is not desired, the gain should be included in gross income for such year or years in the regular manner. A failure to so include such gain in gross income in the regular manner shall be deemed to be an election by the taxpayer to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph even though the details in connection with the conversion are not reported in such return. If, after having made an election under section 1033(a)(2), the converted property is not replaced within the required period of time, or replacement is made at a cost lower than was anticipated at the time of the election, or a decision is made not to replace, the tax liability for the year or years for which the election was made shall be recomputed. Such recomputation should be in the form of an *amended return*. If a decision is made to make an election under section 1033(a)(2) after the filing of the return and the payment of the tax for the year or years in which any of the gain

on an involuntary conversion is realized and before the expiration of the period within which the converted property must be replaced, a claim for credit or refund for such year or years should be filed. If the replacement of the converted property occurs in a year or years in which none of the gain on the conversion is realized, all of the details in connection with such replacement shall be reported in the return for such year or years.

(3) The period referred to in subparagraphs (1) and (2) of this paragraph is the period of time commencing with the date of the disposition of the converted property, or the date of the beginning of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ending 2 years (or, in the case of a disposition occurring before December 31, 1969, 1 year) after the close of the first taxable year in which any part of the gain upon the conversion is realized, or at the close of such later date as may be designated pursuant to an application of the taxpayer. Such application shall be made prior to the expiration of 2 years (or, in the case of a disposition occurring before December 31, 1969, 1 year) after the close of the first taxable year in which any part of the gain from the conversion is realized, unless the taxpayer can show to the satisfaction of the district director—

(i) Reasonable cause for not having filed the application within the required period of time, and

(ii) The filing of such application was made within a reasonable time after the expiration of the required period of time. The application shall contain all of the details in connection with the involuntary conversion. Such application shall be made to the district director for the internal revenue district in which the return is filed for the first taxable year in which any of the gain from the involuntary conversion is realized. No extension of time shall be granted pursuant to such application unless the taxpayer can show reasonable cause for not being able to replace the converted property within the required period of time.

See section 1033(g)(4) and § 1.1033(g)–1 for the circumstances under which, in the case of the conversion of real property held either for productive use in trade or business or for investment, the 2-year period referred to in this paragraph (c)(3) shall be extended to 3 years.

(4) Property or stock purchased before the disposition of the converted property shall be considered to have been purchased for the purpose of replacing the converted property only if such property or stock is held by the taxpayer on the date of the disposition of the converted property. Property or stock shall be considered to have been purchased only if, but for the provisions of section 1033(b), the unadjusted basis of such property or stock would be its cost to the taxpayer within the meaning of section 1012. If the taxpayers unadjusted basis of the replacement property would be determined, in the absence of section 1033(b), under any of the exceptions referred to in section 1012, the unadjusted basis of the property would not be its cost within the meaning of section 1012. For example, if property similar or related in service or use to the converted property is acquired by gift and its basis is determined under section 1015, such property will not qualify as a replacement for the converted property.

(5) If a taxpayer makes an election under section 1033(a)(2), any deficiency, for any taxable year in which any part of the gain upon the conversion is realized, which is attributable to such gain may be assessed at any time before the expiration of three years from the date the district director with whom the return for such year has been filed is notified by the taxpayer of the replacement of the converted property or of an intention not to replace, or of a failure to replace, within the required period, notwithstanding the provisions of section 6212(c) or the provisions of any other law or rule of law which would otherwise prevent such assessment. If replacement has been made, such notification shall contain all of the details in connection with such replacement. Such notification should be made in the return for the taxable year or years in which the replacement occurs, or the intention not to replace is formed, or the period for replacement expires, if this return is filed with such district

director. If this return is not filed with such district director, then such notification shall be made to such district director at the time of filing this return. If the taxpayer so desires, he may, in either event, also notify such district director before the filing of such return.

(6) If a taxpayer makes an election under section 1033(a)(2) and the replacement property or stock was purchased before the beginning of the last taxable year in which any part of the gain upon the conversion is realized, any deficiency, for any taxable year ending before such last taxable year, which is attributable to such election may be assessed at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed, notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any law or rule of law which would otherwise prevent such assessment.

(7) If the taxpayer makes an election under section 1033(a)(2), the gain upon the conversion shall be recognized to the extent that the amount realized upon such conversion exceeds the cost of the replacement property or stock, regardless of whether such amount is realized in one or more taxable years.

(8) The proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.

(9) There is no investment in property similar in character and devoted to a similar use if—

(i) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(ii) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase or a leasehold.

(iii) The owner of a requisitioned tug uses the proceeds to buy barges.

(10) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation, the amount so retained shall be deducted from the gross award in determining the amount of the net award.

(11) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation) and mortgages against the property, and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the amount of the net award. If, in a condemnation proceeding, the Government makes an award to a mortgagee to satisfy a mortgage on the condemned property, the amount of such award shall be considered as a part of the *amount realized* upon the conversion regardless of whether or not the taxpayer was personally liable for the mortgage debt. Thus, if a taxpayer has acquired property worth $100,000 subject to a $50,000 mortgage (regardless of whether or not he was personally liable for the mortgage debt) and, in a condemnation proceeding, the Government awards the taxpayer $60,000 and awards the mortgagee $50,000 in satisfaction of the mortgage, the entire $110,000 is considered to be the *amount realized* by the taxpayer.

(12) An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805)

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6679, 28 FR 10515, Oct. 1, 1963; T.D. 7075, 35 FR 17996, Nov. 24, 1970; T.D. 7625, 44 FR 31013, May 30, 1979; T.D. 7758, 46 FR 6925, Jan. 22, 1981]

§ 1.1033(a)–3 Involuntary conversion of principal residence.

Section 1033 shall apply in the case of property used by the taxpayer as his principal residence if the destruction, theft, seizure, requisition, or condemnation of such residence, or the sale or exchange of such residence

under threat or imminence thereof, occurs before January 1, 1951, or after December 31, 1953. However, section 1033 shall not apply to the seizure, requisition, or condemnation (but not destruction), or the sale or exchange under threat or imminence thereof, of such residence property if the seizure, requisition, condemnation, sale, or exchange occurs after December 31, 1957, and if the taxpayer properly elects under section 1034(i) to treat the transaction as a sale (see paragraph (h)(2)(ii) of § 1.1034–1). See section 121 and paragraphs (d) and (g) of § 1.121–5 for special rules relating to the involuntary conversion of a principal residence of individuals who have attained age 65.

[T.D. 6856, 30 FR 13319, Oct. 20, 1965. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1033(b)–1 Basis of property acquired as a result of an involuntary conversion.

(a) The provisions of the first sentence of section 1033(b) may be illustrated by the following example:

Example: A's vessel which has an adjusted basis of $100,000 is destroyed in 1950 and A receives in 1951 insurance in the amount of $200,000. If A invests $150,000 in a new vessel, taxable gain to the extent of $50,000 would be recognized. The basis of the new vessel is $100,000; that is, the adjusted basis of the old vessel ($100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel ($50,000) plus the amount of gain recognized upon the conversion ($50,000). If any amount in excess of the proceeds of the conversion is expended in the acquisition of the new property, such amount may be added to the basis otherwise determined.

(b) The provisions of the last sentence of section 1033(b) may be illustrated by the following example:

Example: A taxpayer realizes $22,000 from the involuntary conversion of his barn in 1955; the adjusted basis of the barn to him was $10,000, and he spent in the same year $20,000 for a new barn which resulted in the nonrecognition of $10,000 of the $12,000 gain on the conversion. The basis of the new barn to the taxpayer would be $10,000—the cost of the new barn ($20,000) less the amount of the gain not recognized on the conversion ($10,000). The basis of the new barn would not be a substituted basis in the hands of the taxpayer within the meaning of section 1016(b)(2). If the replacement of the converted barn had been made by the purchase of two smaller barns which, together, were similar or related in service or use to the converted barn and which cost $8,000 and $12,000, respectively, then the basis of the two barns would be $4,000 and $6,000, respectively, the total basis of the purchased property ($10,000) allocated in proportion to their respective costs (8,000/ 20,000 of $10,000 or $4,000; and 12,000/20,000 of $10,000, or $6,000).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1033(c)–1 Disposition of excess property within irrigation project deemed to be involuntary conversion.

(a) The sale, exchange, or other disposition occurring in a taxable year to which the Internal Revenue Code of 1954 applies, of excess lands lying within an irrigation project or division in order to conform to acreage limitations of the Federal reclamation laws effective with respect to such project or division shall be treated as an involuntary conversion to which the provisions of section 1033 and the regulations thereunder shall be applicable. The term *excess lands* means irrigable lands within an irrigation project or division held by one owner in excess of the amount of irrigable land held by such owner entitled to receive water under the Federal reclamation laws applicable to such owner in such project or division. Such excess lands may be either (1) lands receiving no water from the project or division, or (2) lands receiving water only because the owner thereof has executed a valid recordable contract agreeing to sell such lands under terms and conditions satisfactory to the Secretary of the Interior.

(b) If a disposition in order to conform to the acreage limitation provisions of Federal reclamation laws includes property other than excess lands (as, for example, where the excess lands alone do not constitute a marketable parcel) the provisions of section 1033(d) shall apply only to the part of the disposition that relates to excess lands.

(c) The provisions of § 1.1033(a)–2 shall be applicable in the case of dispositions treated as involuntary conversions under this section. The details in connection with such a disposition required to be reported under paragraph

(c)(2) of § 1.1033(a)–2 shall include the authority whereby the lands disposed of are considered *excess lands*, as defined in this section, and a statement that such disposition is not part of a plan contemplating the disposition of all or any nonexcess land within the irrigation project or division.

(d) The term *involuntary conversion*, where it appears in subtitle A of the Code or the regulations thereunder, includes dispositions of excess property within irrigation projects described in this section. (See, e.g., section 1231 and the regulations thereunder.)

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1033(d)–1 Destruction or disposition of livestock because of disease.

(a) The destruction occurring in a taxable year to which the Internal Revenue Code of 1954 applies, of livestock by, or on account of, disease, or the sale or exchange, in such a year, of livestock because of disease, shall be treated as an involuntary conversion to which the provisions of section 1033 and the regulations thereunder shall be applicable. Livestock which are killed either because they are diseased or because of exposure to disease shall be considered destroyed on account of disease. Livestock which are sold or exchanged because they are diseased or have been exposed to disease, and would not otherwise have been sold or exchanged at that particular time shall be considered sold or exchanged because of disease.

(b) The provisions of § 1.1033(a)–2 shall be applicable in the case of a disposition treated as an involuntary conversion under this section. The details in connection with such a disposition required to be reported under paragraph (c)(2) of § 1.1033(a)–2 shall include a recital of the evidence that the livestock were destroyed by or on account of disease, or sold or exchanged because of disease.

(c) The term *involuntary conversion*, where it appears in subtitle A of the Code or the regulations thereunder, includes disposition of livestock described in this section. (See, e.g., section 1231 and the regulations thereunder.)

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated by T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1033(e)–1 Sale or exchange of livestock solely on account of drought.

(a) The sale or exchange of livestock (other than poultry) held for draft, breeding, or dairy purposes in excess of the number the taxpayer would sell or exchange during the taxable year if he followed his usual business practices shall be treated as an involuntary conversion to which section 1033 and the regulations thereunder are applicable if the sale or exchange of such livestock by the taxpayer is solely on account of drought. Section 1033(e) and this section shall apply only to sales and exchanges occurring after December 31, 1955.

(b) To qualify under section 1033(e) and this section, the sale or exchange of the livestock need not take place in a drought area. While it is not necessary that the livestock be held in a drought area, the sale or exchange of the livestock must be solely on account of drought conditions the existence of which affected the water, grazing, or other requirements of the livestock so as to necessitate their sale or exchange.

(c) The total sales or exchanges of livestock held for draft, breeding, or dairy purposes occurring in any taxable year which may qualify as an involuntary conversion under section 1033(e) and this section is limited to the excess of the total number of such livestock sold or exchanged during the taxable year over the number that the taxpayer would have sold or exchanged if he had followed his usual business practices, that is, the number he would have been expected to sell or exchange under ordinary circumstances if there had been no drought. For example, if in the past it has been a taxpayer's practice to sell or exchange annually one-half of his herd of dairy cows, only the number sold or exchanged solely on account of drought conditions which is in excess of one-half of his herd, may qualify as an involuntary conversion under section 1033(e) and this section.

(d) The replacement requirements of section 1033 will be satisfied only if the livestock sold or exchanged is replaced within the prescribed period with livestock which is similar or related in service or use to the livestock sold or exchanged because of drought, that is, the new livestock must be functionally the same as the livestock involuntarily converted. This means that the new livestock must be held for the same useful purpose as the old was held. Thus, although dairy cows could be replaced by dairy cows, a taxpayer could not replace draft animals with breeding or dairy animals.

(e) The provisions of § 1.1033(a)–2 shall be applicable in the case of a sale or exchange treated as an involuntary conversion under this section. The details in connection with such a disposition required to be reported under paragraph (c)(2) of § 1.1033(a)–2 shall include:

(1) Evidence of the existence of the drought conditions which forced the sale or exchange of the livestock;

(2) A computation of the amount of gain realized on the sale or exchange;

(3) The number and kind of livestock sold or exchanged; and

(4) The number of livestocks of each kind that would have been sold or exchanged under the usual business practice in the absence of the drought.

(f) The term *involuntary conversion*, where it appears in subtitle A of the Code or the regulations thereunder, includes the sale or exchange of livestock described in this section.

(g) The provisions of section 1033(e) and this section apply to taxable years ending after December 31, 1955, but only in the case of sales or exchange of livestock after December 31, 1955.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated by T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1033(g)–1 Condemnation of real property held for productive use in trade or business or for investment.

(a) *Special rule in general.* This section provides special rules for applying section 1033 with respect to certain dispositions, occurring after December 31, 1957, of real property held either for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale). For this purpose, disposition means the seizure, requisition, or condemnation (but not destruction) of the converted property, or the sale or exchange of such property under threat or imminence of seizure, requisition, or condemnation. In such cases, for purposes of applying section 1033, the replacement of such property with property of like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted. For principles in determining whether the replacement property is property of like kind, see paragraph (b) of § 1.1031(a)–1.

(b) *Election to treat outdoor advertising displays as real property*—(1) *In general.* Under section 1033(g)(3) of the Code, a taxpayer may elect to treat property which constitutes an outdoor advertising display as real property for purposes of chapter 1 of the Code. The election is available for taxable years beginning after December 31, 1970. In the case of an election made on or before July 21, 1981, the election is available whether or not the period for filing a claim for credit or refund under section 6511 has expired. No election may be made with respect to any property for which (i) the investment credit under section 38 has been claimed, or (ii) an election to expense certain depreciable business assets under section 179(a) is in effect. The election once made applies to all outdoor advertising displays of the taxpayer which may be made the subject of an election under this paragraph, including all outdoor advertising displays acquired or constructed by the taxpayer in a taxable year after the taxable year for which the election is made. The election applies with respect to dispositions during the taxable year for which made and all subsequent taxable years (unless an effective revocation is made pursuant to paragraph (b)(2) (ii) or (iii)).

(2) *Election*—(i) *Time and manner of making election*—(A) *In general.* Unless otherwise provided in the return or in the instructions for a return for a taxable year, any election made under section 1033(g)(3) shall be made by attaching a statement to the return (or amended return if filed on or before

July 21, 1981) for the first taxable year to which the election is to apply. Any election made under this paragraph must be made not later than the time, including extensions thereof, prescribed by law for filing the income tax return for such taxable year or July 21, 1981, whichever occurs last. If a taxpayer makes an election (or revokes an election under subdivision (ii) or (iii) of this subparagraph (b) (2)) for a taxable year for which he or she has previously filed a return, the return for that taxable year and all other taxable years affected by the election (or revocation) must be amended to reflect any tax consequences of the election (or revocation). However, no return for a taxable year for which the period for filing a claim for credit or refund under section 6511 has expired may be amended to make any changes other than those resulting from the election (or revocation). In order for the election (or revocation) to be effective, the taxpayer must remit with the amended return any additional tax due resulting from the election (or revocation), notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any other law which would prevent assessment or collection of such tax.

(B) *Statement required when making election*. The statement required when making the election must clearly indicate that the election to treat outdoor advertising displays as real property is being made.

(ii) *Revocation of election by Commissioner's consent*. Except as otherwise provided in paragraph (b)(2)(iii) of this section, an election under section 1033(g)(3) shall be irrevocable unless consent to revoke is obtained from the Commissioner. In order to secure the Commissioner's consent to revoke an election, the taxpayer must file a request for revocation of election with the Commissioner of Internal Revenue, Washington, DC 20224. The request for revocation shall include—

(A) The taxpayer's name, address, and taxpayer identification number,

(B) The date on which and taxable year for which the election was made and the Internal Revenue Service office with which it was filed,

(C) Identification of all outdoor advertising displays of the taxpayer to which the revocation would apply (including the location, date of purchase, and adjusted basis in such property),

(D) The effective date desired for the revocation, and

(E) The reasons for requesting the revocation.

The Commissioner may require such other information as may be necessary in order to determine whether the requested revocation will be permitted. The Commissioner may prescribe administrative procedures (subject to such limitations, terms and conditions as he deems necessary) to obtain his consent to permit the taxpayer to revoke the election. The taxpayer may submit a request for revocation for any taxable year for which the period of limitations for filing a claim for credit or refund or overpayment of tax has not expired.

(iii) *Revocation where election was made on or before December 11, 1979*. In the case of an election made on or before December 11, 1979, the taxpayer may revoke such election provided such revocation is made not later than March 23, 1981. The request for revocation shall be made in conformity with the requirements of paragraph (b)(2)(ii), except that, in lieu of the information required by paragraph (b)(2)(ii)(E), the taxpayer shall state that the revocation is being made pursuant to this paragraph. In addition, the taxpayer must forward, with the statement of revocation, copies of his or her tax returns, including both the original return and any amended returns, for the taxable year in which the original election was made and for all subsequent years and must remit any additional tax due as a result of the revocation.

(3) *Definition of outdoor advertising display*. The term *outdoor advertising display* means a rigidly assembled sign, display, or device that constitutes, or is used to display, a commercial or other advertisement to the public and is permanently affixed to the ground or permanently attached to a building or other inherently permanent structure. The term includes highway billboards affixed to the ground with wood or metal poles, pipes, or beams, with or without concrete footings.

(4) *Character of replacement property.* For purposes of section 1033(g), an interest in real property purchased as replacement property for a compulsorily or involuntarily converted outdoor advertising display (with respect to which an election under this section is in effect) shall be considered property of a like kind as the property converted even though a taxpayer's interest in the replacement property is different from the interest held in the property converted. Thus, for example, a fee simple interest in real estate acquired to replace a converted billboard and a 5-year leasehold interest in the real property on which the billboard was located qualifies as property of a like kind under this section.

(c) *Special rule for period within which property must be replaced.* In the case of a disposition described in paragraph (a) of this section, section 1033(a)(2)(B) and § 1.1033(a)–2(c)(3) (relating to the period within which the property must be replaced) shall be applied by substituting 3 years for 2 years. This paragraph shall apply to any disposition described in section 1033(f)(1) and paragraph (a) of this section occurring after December 31, 1974, unless a condemnation proceeding with respect to the property was begun before October 4, 1976. Thus, regardless of when the property is disposed of, the taxpayer will not be eligible for the 3-year replacement period if a condemnation proceeding was begun before October 4, 1976. However, if the property is disposed of after December 31, 1974, and the condemnation proceeding was begun (if at all) after October 4, 1976, then the taxpayer is eligible for the 3-year replacement period. For the purposes of this paragraph, whether a condemnation proceeding is considered as having begun is determined under the applicable State or Federal procedural law.

(d) *Limitation on application of special rule.* This section shall not apply to the purchase of stock in the acquisition of control of a corporation described in section 1033(a)(2)(A).

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979; 44 FR 38458, July 2, 1979. Further redesignated and amended by T.D. 7758, 46 FR 6925, Jan. 22, 1981; T.D. 7758, 46 FR 23235, Apr. 24, 1981; T.D. 8121, 52 FR 414, Jan. 6, 1987]

§ 1.1033(h)–1 Effective date.

Except as provided otherwise in § 1.1033(e)–1 and § 1.1033(g)–1, the provisions of section 1033 and the regulations thereunder are effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954.

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979. Further redesignated and amended by T.D. 7758, 46 FR 6925, Jan. 22, 1981]

§ 1.1035–1 Certain exchanges of insurance policies.

Under the provisions of section 1035 no gain or loss is recognized on the exchange of:

(a) A contract of life insurance for another contract of life insurance or for an endowment or annuity contract (section 1035(a)(1));

(b) A contract of endowment insurance for another contract of endowment insurance providing for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or an annuity contract (section 1035(a)(2)); or

(c) An annuity contract for another annuity contract (section 1035(a)(3)), but section 1035 does not apply to such exchanges if the policies exchanged to not relate to the same insured. The exchange, without recognition of gain or loss, of an annuity contract for another annuity contract under section 1035(a)(3) is limited to cases where the same person or persons are the obligee or obligees under the contract received in exchange as under the original contract. This section and section 1035 do not apply to transactions involving the exchange of an endowment contract or

annuity contract for a life insurance contract, nor an annuity contract for an endowment contract. In the case of such exchanges, any gain or loss shall be recognized. In the case of exchanges which would be governed by section 1035 except for the fact that the property received in exchange consists not only of property which could otherwise be received without the recognition of gain or loss, but also of other property or money, see section 1031 (b) and (c) and the regulations thereunder. Such an exchange does not come within the provisions of section 1035. Determination of the basis of property acquired in an exchange under section 1035(a) shall be governed by section 1031(d) and the regulations thereunder.

§ 1.1036–1 Stock for stock of the same corporation.

(a) Section 1036 permits the exchange, without the recognition of gain or loss, of common stock for common stock, or of preferred stock for preferred stock, in the same corporation. Section 1036 applies even though voting stock is exchanged for nonvoting stock or nonvoting stock is exchanged for voting stock. It is not limited to an exchange between two individual stockholders; it includes a transaction between a stockholder and the corporation. However, a transaction between a stockholder and the corporation may qualify not only under section 1036(a), but also under section 368(a)(1)(E) (recapitalization) or section 305(a) (distribution of stock and stock rights). The provisions of section 1036(a) do not apply if stock is exchanged for bonds, or preferred stock is exchanged for common stock, or common stock is exchanged for preferred stock, or common stock in one corporation is exchanged for common stock in another corporation. See paragraph (l) of section 1301–1 for certain transactions treated as distributions under section 301. See paragraph (e)(5) of § 1.368–2 for certain transactions which result in deemed distributions under section 305(c) to which sections 305(b)(4) and 301 apply.

(b) For rules relating to recognition of gain or loss where an exchange is not wholly in kind, see subsections (b) and (c) of section 1031. For rules relating to the basis of property acquired in an exchange described in paragraph (a) of this section, see subsection (d) of section 1031.

(c) A transfer is not within the provisions of section 1036(a) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer (or if the property transferred is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of section 1031(b).

(d) *Nonqualified preferred stock.* See § 1.356–7(a) for the applicability of the definition of nonqualified preferred stock in section 351(g)(2) for stock issued prior to June 9, 1997, and for stock issued in transactions occurring after June 8, 1997, that are described in section 1014(f)(2) of the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 788, 921).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7281, 38 FR 18540, July 12, 1973; T.D. 8904, 65 FR 58652, Oct. 2, 2000]

§ 1.1037–1 Certain exchanges of United States obligations.

(a) *Nonrecognition of gain or loss*—(1) *In general.* Section 1037(a) provides for the nonrecognition of gain or loss on the surrender to the United States of obligations of the United States issued under the Second Liberty Bond Act (31 U.S.C. 774(2)) when such obligations are exchanged solely for other obligations issued under that Act and the Secretary provides by regulations promulgated in connection with the issue of such other obligations that gain or loss is not to be recognized on such exchange. It is not necessary that at the time of the exchange the obligation which is surrendered to the United States be a capital asset in the hands of the taxpayer. For purposes of section 1037(a) and this subparagraph, a circular of the Treasury Department which offers to exchange obligations of the United States issued under the Second Liberty Bond Act for other obligations issued under that Act shall constitute regulations promulgated by the Secretary in connection with the issue of the obligations offered to be exchanged if such circular contains a declaration by the Secretary that no gain or loss shall be recognized for Federal income tax purposes on the exchange

or grants the privilege of continuing to defer the reporting of the income of the bonds exchanged until such time as the bonds received in the exchange are redeemed or disposed of, or have reached final maturity, whichever is earlier. See, for example, regulations of the Bureau of the Public Debt, 31 CFR part 339, or Treasury Department Circular 1066, 26 FR 8647. The application of section 1037(a) and this subparagraph will not be precluded merely because the taxpayer is required to pay money on the exchange. See section 1031 and the regulations thereunder if the taxpayer receives money on the exchange.

(2) *Recognition of gain or loss postponed*. Gain or loss which has been realized but not recognized on the exchange of a U.S. obligation for another such obligation because of the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as related to section 1037(a)) shall be recognized at such time as the obligation received in the exchange is disposed of, or redeemed, in a transaction other than an exchange described in section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) or reaches final maturity, whichever is earlier, to the extent gain or loss is realized on such later transaction.

(3) *Illustrations*. The application of this paragraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and has never elected under section 454(a) to include in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In addition, it is assumed that the old obligations exchanged are capital assets transferred in an exchange in respect of which regulations are promulgated pursuant to section 1037(a):

Example 1. A, the owner of a $1,000 series E U.S. savings bond purchased for $750 and bearing an issue date of May 1, 1945, surrenders the bond to the United States in exchange solely for series H U.S. savings bonds on February 1, 1964, when the series E bond has a redemption value of $1,304.80. In the exchange A pays an additional $195.20 and obtains three $500 series H bonds. None of the $554.80 gain ($1,304.80 less $750) realized by A on the series E bond is recognized at the time of the exchange.

Example 2. In 1963, B purchased for $97 a marketable U.S. bond which was originally issued at its par value of $100. In 1964 he surrenders the bond to the United States in exchange solely for another marketable U.S. bond which then has a fair market value of $95. B's loss of $2 on the old bond is not recognized at the time of the exchange, and his basis for the new bond is $97 under section 1031(d). If it has been necessary for B to pay $1 additional consideration in the exchange, his basis in the new bond would be $98.

Example 3. The facts are the same as in example (2) except that B also receives $1 interest on the old bond for the period which has elapsed since the last interest payment date and that B does not pay any additional consideration on the exchange. As in example (2), B has a loss of $2 which is not recognized at the time of the exchange and his basis in the new bond is $97. In addition, the $1 of interest received on the old bond is includible in gross income. B holds the new bond 1 year and sells it in the market for $99 plus interest. At this time he has a gain of $2, the difference between his basis of $97 in the new bond and the sales price of such bond. In addition, the interest received on the new bond is includible in gross income.

Example 4. The facts are the same as in example (2), except that in addition to the new bond B also receives $1.85 in cash, $0.85 of which is interest. The $0.85 interest received is includible in gross income. B's loss of $1 ($97 less $96) on the old bond is not recognized at the time of the exchange by reason of section 1031(c). Under section 1031(d) B's basis in the new bond is $96 (his basis of $97 in the old bond, reduced by the $1 cash received in the exchange).

Example 5. (a) For $975 D subscribes to a marketable U.S. obligation which has a face value of $1,000. Thereafter, he surrenders this obligation to the United States in exchange solely for a 10-year marketable $1,000 obligation which at the time of exchange has a fair market value of $930, at which price such obligation is initially offered to the public. At the time of issue of the new obligation there was no intention to call it before maturity. Five years after the exchange D sells the new obligation for $960.

(b) On the exchange of the old obligation for the new obligation D sustains a loss of $45 ($975 less $930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new obligation in D's hands, determined under section 1031(d), is $975 (the same basis as that of the old obligation).

(d) On the sale of the new obligation D sustains a loss of $15 ($975 less $960), all of which is recognized by reason of section 1002.

Example 6. (a) The facts are the same as in example (5), except that five years after the exchange D sells the new obligation for $1,020.

(b) On the exchange of the old obligation for the new obligation D sustains a loss of $45 ($975 less $930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new obligation in D's hands, determined under section 1031(d), is $975 (the same basis as that of the old obligation). The issue price of the new obligation under section 1232(b)(2) is $930.

(d) On the sale of the new obligation D realizes a gain of $45 ($1,020 less $975), all of which is recognized by reason of section 1002. Of this gain of $45, the amount of $35 is treated as ordinary income and $10 is treated as long-term capital gain, determined as follows:

(1) Ordinary income under first sentence of section 1232(a)(2)(B) on sale of new obligation:	
Stated redemption price of new obligation at maturity	$1,000
Less: Issue price of new obligation under section 1232(b)(2)	930
Original issue discount on new obligation	70
Proration under section 1232(a)(2)(B)(ii): ($70 × 60 months/120 months)	35
(2) Long-term capital gain ($45 less $35)	10

Example 7. (a) The facts are the same as in example (5), except that D retains the new obligation and redeems it at maturity for $1,000.

(b) On the exchange of the old obligation for the new obligation D sustains a loss of $45 ($975 less $930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new obligation in D's hands, determined under section 1031(d), is $975 (the same basis as that of the old obligation). The issue price of the new obligation is $930 under section 1232(b)(2).

(d) On the redemption of the new obligation D realizes a gain of $25 ($1,000 less $975), all of which is recognized by reason of section 1002. Of this gain of $25, the entire amount is treated as ordinary income, determined as follows:

Ordinary income under first sentence of section 1232(a)(2)(B) on redemption of new obligation:	
Stated redemption price of new obligation at maturity	$1,000
Less: Issue price of new obligation under section 1232(b)(2)	930
Original issue discount on new obligation	70
Proration under section 1232(a)(2)(B)(ii): ($70 × 120 months/120 months), but such amount not to exceed the $25 gain recognized on redemption	25

(b) *Application of section 1232 upon disposition or redemption of new obligation*—(1) *Exchanges involving nonrecognition of gain on obligations issued at a discount.* If an obligation, the gain on which is subject to the first sentence of section 1232(a)(2)(B), because the obligation was originally issued at a discount, is surrendered to the United States in exchange for another obligation and any part of the gain realized on the exchange is not then recognized because of the provisions of section 1037(a) (or because of so much of section 1031(b) as relates to section 1037(a)), the first sentence of section 1232(a)(2)(B) shall apply to so much of such unrecognized gain as is later recognized upon the disposition or redemption of the obligation which is received in the exchange as though the obligation so disposed of or redeemed were the obligation surrendered, rather than the obligation received, in such exchange. See the first sentence of section 1037(b)(1). Thus, in effect that portion of the gain which is unrecognized on the exchange but is recognized upon the later disposition or redemption of the obligation received from the United States in the exchange shall be considered as ordinary income in an amount which is equal to the gain which, by applying the first sentence of section 1232(a)(2)(B) upon the earlier surrender of the old obligation to the United States, would have been considered as ordinary income if the gain had been recognized upon such earlier exchange. Any portion of the gain which is recognized under section 1031(b) upon the earlier exchange and is treated at such time as ordinary income shall be deducted from the gain which is treated as ordinary income by applying the first sentence of section 1232(a)(2)(B) pursuant to this subparagraph upon the disposition or redemption of the obligation which is received in the earlier exchange. This subparagraph shall apply only in a case where on the exchange of United States obligations there was some gain not recognized by reason of section 1037(a) (or so much of section 1031(b) as relates to section 1037(a)); it shall not apply where, only loss was unrecognized by reason of section 1037(a).

(2) *Rules to apply when a nontransferable obligation is surrendered in the exchange.* For purposes of applying both section 1232(a)(2)(B) and subparagraph (1) of this paragraph to the total gain realized on the obligation which is later disposed of or redeemed, if the obligation surrendered to the United

States in the earlier exchange is a nontransferable obligation described in section 454 (a) or (c)—

(i) The aggregate amount considered, with respect to the obligation so surrendered in the earlier exchange, as ordinary income shall not exceed the difference between the issue price of the surrendered obligation and the stated redemption price of the surrendered obligation which applied at the time of the earlier exchange, and

(ii) The issue price of the obligation which is received from the United States in the earlier exchange shall be considered to be the stated redemption price of the surrendered obligation which applied at the time of the earlier exchange, increased by the amount of other consideration (if any) paid to the United States as part of the earlier exchange.

If the obligation received in the earlier exchange is a nontransferable obligation described in section 454(c) and such obligation is partially redeemed before final maturity or partially disposed of by being partially reissued to another owner, the amount determined by applying subdivision (i) of this subparagraph shall be determined on a basis proportional to the total denomination of obligations redeemed or disposed of. See paragraph (c) of § 1.454–1.

(3) *Long-term capital gain*. If, in a case where both subparagraphs (1) and (2) of this paragraph are applied, the total gain realized on the redemption or disposition of the obligation which is received from the United States in the exchange to which section 1037(a) (or so much of section 1031(b) as related to section 1037(a)) applies exceeds the amount of gain which, by applying such subparagraphs, is treated as ordinary income, the gain in excess of such amount shall be treated as long-term capital gain.

(4) *Illustrations*. The application of this paragraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and has never elected under section 454(a) to include in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In addition, it is assumed that the old obligations exchanged are capital assets transferred in an exchange in respect of which regulations are promulgated pursuant to section 1037(a):

Example 1. (a) A purchased a noninterest-bearing nontransferable U.S. bond for $74 which was issued after December 31, 1954, and redeemable in 10 years for $100. Several years later, when the stated redemption value of such bond is $94.50, A surrenders it to the United States in exchange for $1 in cash and a 10-year marketable bond having a face value of $100. On the date of exchange the bond received in the exchange has a fair market value of $96. Less than one month after the exchange, A sells the new bond for $96.

(b) On the exchange of the old bond for the new bond A realizes a gain of $23, determined as follows:

Amount realized (a new bond worth $96 plus $1 cash)	$97
Less: Adjusted basis of old bond	74
Gain realized	23

Pursuant to so much of section 1031(b) as applies to section 1037(a), the amount of such gain which is recognized is $1 (the money received). Such recognized gain of $1 is treated as ordinary income. On the exchange of the old bond a gain of $22 ($23 less $1) is not recognized.

(c) The basis of the new bond in A's hands, determined under section 1031(d) is $74 (the basis of the old bond, decreased by the $1 received in cash and increased by the $1 gain recognized on the exchange).

(d) On the sale of the new bond A realizes a gain of $22 ($96 less $74), all of which is recognized by reason of section 1002. Of this gain of $22, the amount of $19.50 is treated as ordinary income and $2.50 is treated as long-term capital gain, determined as follows:

(1) Ordinary income, treating sale of new bond as though a sale of old bond and applying section 1037(b)(1)(A):		
Stated redemption price of old bond		$94.50
Less: Issue price of old bond		74.00
Aggregate gain under section 1037(b)(1)(A) (not to exceed $22 not recognized at time of exchange)		20.50
Less: Amount of such gain recognized at time of exchange		1.00
Ordinary income		19.50
(2) Ordinary income under first sentence of section 1232(a)(2)(B), applying section 1037(b)(1)(B) to sale of new bond:		
Stated redemption price of new bond at maturity	$100.00	
Less: Issue price of new bond under section 1037(b)(1)(B) ($94.50 plus $0 additional consideration paid on exchange)	94.50	

Original issue discount on new bond	5.50	
Proration under section 1232(a)(2)(B)(ii): ($5.50 × 0 months/120 months)		0
(3) Total ordinary income (sum of subparagraphs (1) and (2))		19.50
(4) Long-term capital gain ($22 less $19.50)		2.50

Example 2. (a) The facts are the same as in example (1), except that, less than one month after the exchange of the old bond, the new bond is sold for $92.

(b) On the sale of the new bond A realizes a gain of $18 ($92 less $74), all of which is recognized by reason of section 1002. Of this gain, the entire amount of $18 is treated as ordinary income. This amount is determined as provided in paragraph (d)(1) of example (1) except that the ordinary income of $19.50 is limited to the $18 recognized on the sale of the new bond.

Example 3. (a) The facts are the same as in example (1), except that 2 years after the exchange of the old bond A sells the new bond for $98.

(b) On the sale of the new bond A realizes a gain of $24 ($98 less $74), all of which is recognized by reason of section 1002. Of this gain of $24, the amount of $20.60 is treated as ordinary income and $3.40 is treated as long-term capital gain, determined as follows:

(1) Ordinary income applicable to old bond (determined as provided in paragraph (d)(1) of example (1))	$19.50
(2) Ordinary income applicable to new bond (determined as provided in paragraph (d)(2) of example (1), except that the proration of the original issue discount under section 1232(a)(2)(B)(ii) amounts to $1.10 ($5.50 × 24 months/120 months)	1.10
(3) Total ordinary income (sum of subparagraphs (1) and (2))	20.60
(4) Long-term capital gain ($24 less $20.60)	3.40

Example 4. (a) The facts are the same as in example (1), except that A retains the new bond and redeems it at maturity for $100.

(b) On the redemption of the new bond A realizes a gain of $26 ($100 less $74), all of which is recognized by reason of section 1002. Of this gain of $26, the amount of $25 is treated as ordinary income and $1 is treated as long-term capital gain, determined as follows:

(1) Ordinary income applicable to old bond (determined as provided in paragraph (d)(1) of example (1))	$19.50
(2) Ordinary income applicable to new bond (determined as provided in paragraph (d)(2) of example (1), except that the proration of the original issue discount under section 1232(a)(2)(B)(ii) amounts to $5.50 ($5.50 × 120 months/120 months))	5.50
(3) Total ordinary income (sum of subparagraphs (1) and (2))	25.00
(4) Long-term capital gain ($26 less $25)	1.00

Example 5. (a) In 1958 B purchased for $7,500 a series E United States savings bond having a face value of $10,000. In 1965 when the stated redemption value of the series E bond is $9,760, B surrenders it to the United States in exchange solely for a $10,000 series H U.S. savings bond, after paying $240 additional consideration. B retains the series H bond and redeems it at maturity in 1975 for $10,000, after receiving all the semiannual interest payments thereon.

(b) On the exchange of the series E bond for the series H bond, B realizes a gain of $2,260 ($9,760 less $7,500), none of which is recognized at such time by reason of section 1037(a).

(c) The basis of the series H bond in B's hands, determined under section 1031(d), is $7,740 (the $7,500 basis of the series E bond, plus $240 additional consideration paid for the series H bond).

(d) On the redemption of the series H bond, B realizes a gain of $2,260 ($10,000 less $7,740), all of which is recognized by reason of section 1002. This entire gain is treated as ordinary income by treating the redemption of the series H bond as though it were a redemption of the series E bond and by applying section 1037(b)(1)(A).

(e) Under section 1037(b)(1)(B) the issue price of the series H bonds is $10,000 ($9,760 stated redemption price of the series E bond at time of exchange, plus $240 additional consideration paid). Thus, with respect to the series H bond, there is no original issue discount to which section 1232(a)(2)(B) might apply.

Example 6. (a) The facts are the same as in example (5), except that in 1970 B submits the $10,000 series H bond to the United States for partial redemption in the amount of $3,000 and for reissuance of the remainder in $1,000 series H savings bonds registered in his name. On this transaction B receives $3,000 cash and seven $1,000 series H bonds, bearing the original issue date of the $10,000 bond which is partially redeemed. The $1,000, series H bonds are redeemed at maturity in 1975 for $7,000.

(b) On the partial redemption of the $10,000 series H bond in 1970 B realizes a gain of $678 ($3,000 less $2,322 [$7,740 × $3,000/$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of §1.454–1. This entire gain is treated as ordinary income, by treating the partial redemption of the series H bond as though it were a redemption of the relevant denominational portion of the series E bond and by applying section 1037(b)(1)(A).

(c) On the redemption at maturity in 1975 of the seven $1,000 series H bonds B realizes a gain of $1,582 ($7,000 less $5,418 [$7,740 × $7,000/$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of §1.454–1. This entire gain is treated as ordinary income, determined in

the manner described in paragraph (b) of this example.

Example 7. (a) The facts are the same as in example (5), except that in 1970 B requests the United States to reissue the $10,000 series H bond by issuing two $5,000 series H bonds bearing the original issue date of such $10,000 bond. One of such $5,000 bonds is registered in B's name, and the other is registered in the name of C, who is B's son. Each $5,000 series H bond is redeemed at maturity in 1975 for $5,000.

(b) On the issuing in 1970 of the $5,000 series H bond to C, B realizes a gain of $1,130 ($5,000 less $3,870 [$7,740 × $5,000/$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of § 1.454–1. This entire gain is treated as ordinary income by treating the transaction as though it were a redemption of the relevant denominational portion of the series E bond and by applying section 1037(b)(1)(A).

(c) On the redemption at maturity in 1975 of the $5,000 series H bond registered in his name B realizes a gain of $1,130 ($5,000 less $3,870 [$7,740 × $5,000/$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of § 1.454–1. This entire gain is treated as ordinary income, determined in the manner described in paragraph (b) of this example.

(d) On the redemption at maturity in 1975 of the $5,000 series H bond registered in his name C does not realize any gain, since the amount realized on redemption does not exceed his basis in the property, determined as provided in section 1015.

(5) *Exchanges involving nonrecognition of gain or loss on transferable obligations issued at not less than par*—(i) *In general.* If a transferable obligation of the United States which was originally issued at not less than par is surrendered to the United States for another transferable obligation in an exchange to which the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) apply, the issue price of the obligation received from the United States in the exchange shall be considered for purposes of applying section 1232 to gain realized on the disposition or redemption of the obligation so received, to be the same as the issue price of the obligation which is surrendered to the United States in the exchange, increased by the amount of other consideration, if any, paid to the United States as part of the exchange. This subparagraph shall apply irrespective of whether there is gain or loss unrecognized on the exchange and irrespective of the fair market value, at the time of the exchange, of either the obligation surrendered to, or the obligation received from, the United States in the exchange.

(ii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and that the old obligations exchanged are capital assets transferred in an exchange in respect of which regulations are promulgated pursuant to section 1037(a):

Example 1. (a) A purchases in the market for $85 a marketable U.S. bond which was originally issued at its par value of $100. Three months later, A surrenders this bond to the United States in exchange solely for another $100 marketable U.S. bond which then has a fair market value of $88. He holds the new bond for 5 months and then sells it on the market for $92.

(b) On the exchange of the old bond for the new bond A realizes a gain of $3 ($88 less $85), none of which is recognized by reason of section 1037(a).

(c) The basis of the new bond in A's hands, determined under section 1031(d), is $85 (the same as that of the old bond). The issue price of the new bond for purposes of section 1232(a)(2)(B) is considered under section 1037(b)(2) to be $100 (the same issue price as that of the old bond).

(d) On the sale of the new bond A realizes a gain of $7 ($92 less $85), all of which is recognized by reason of section 1002. Of this gain of $7, the entire amount is treated as long-term capital gain, determined as follows:

(1) Ordinary income under first sentence of section 1232(a)(2)(B), applicable to old bond:		
Stated redemption price of old bond at maturity	$100	
Less: Issue price of old bond	100	
Original issue discount on old bond		0
(2) Ordinary income under first sentence of section 1232(a)(2)(B), applying section 1037(b)(2) to sale of new bond:		
Stated redemption price of new bond at maturity	100	
Less: Issue price of new bond under section 1037(b)(2)	100	
Original issue discount on new bond		0
(3) Long-term capital gain ($7 less sum of subparagraphs (1) and (2))		$7

Example 2. The facts are the same as in example (1), except that A retains the new bond and redeems it at maturity for $100. On the redemption of the new bond, A realizes a gain of $15 ($100 less $85), all of which is recognized under section 1002. This entire gain

is treated as long-term capital gain, determined in the same manner as provided in paragraph (d) of example (1).

Example 3. (a) For $1,000 B subscribes to a marketable U.S. bond which has a face value of $1,000. Thereafter, he surrenders this bond to the United States in exchange solely for a 10-year marketable $1,000 bond which at the time of exchange has a fair market value of $930, at which price such bond is initially offered to the public. Five years after the exchange, B sells the new bond for $950.

(b) On the exchange of the old bond for the new bond, B sustains a loss of $70 ($1,000 less $930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new bond in A's hands, determined under section 1031(d), is $1,000 (the same basis as that of the old bond).

(d) On the sale of the new bond B sustains a loss of $50 ($1,000 less $950), all of which is recognized by reason of section 1002.

Example 4. (a) The facts are the same as in example (3), except that 5 years after the exchange B sells the new bond for $1,020.

(b) On the exchange of the old bond for the new bond B sustains a loss of $70 ($1,000 less $930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new bond in B's hands, determined under section 1031(d), is $1,000 (the same basis as that of the old bond). The issue price of the new bond for purposes of section 1232(a)(2)(B) is considered under section 1037(b)(2) to be $1,000 (the same issue price as that of the old bond).

(d) On the sale of the new bond B realizes a gain of $20 ($1,020 less $1,000), all of which is recognized by reason of section 1002. This entire gain is treated as long-term capital gain, determined in the same manner as provided in paragraph (d) of example (1).

(6) *Other rules for applying section 1232.* To the extent not specifically affected by the provisions of section 1037(b) and subparagraphs (1) through (5) of this paragraph, any gain realized on the disposition or redemption of any obligation received from the United States in an exchange to which section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) applies shall be treated in the manner provided by section 1232 if the facts and circumstances relating to the acquisition and disposition or redemption of such obligation require the application of section 1232.

(c) *Holding period of obligation received in the exchange.* The holding period of an obligation received from the United States in an exchange to which the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) apply shall include the period for which the obligation which was surrendered to the United States in the exchange was held by the taxpayer, but only if the obligation so surrendered was at the time of the exchange a capital asset in the hands of the taxpayer. See section 1223 and the regulations thereunder.

(d) *Basis.* The basis of an obligation received from the United States in an exchange to which the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) apply shall be determined as provided in section 1031(d) and the regulations thereunder.

(e) *Effective date.* Section 1.1037 and this section shall apply only for taxable years ending after September 22, 1959.

[T.D. 6935, 32 FR 15824, Nov. 17, 1967, as amended by T.D. 7154, 36 FR 24998, Dec. 28, 1971]

§ 1.1038–1 Reacquisitions of real property in satisfaction of indebtedness.

(a) *Scope of section 1038*—(1) *General rule on gain or loss.* If a sale of real property gives rise to indebtedness to the seller which is secured by the real property which is sold, and the seller of such property reacquires such property in a taxable year beginning after September 2, 1964, in partial or full satisfaction of such indebtedness, then, except as provided in paragraphs (b) and (f) of this section, no gain or loss shall result to the seller from such reacquisition. The treatment so provided is mandatory; however, see § 1.1038–3 for an election to apply the provisions of this section to certain taxable years beginning after December 31, 1957. It is immaterial, for purposes of applying this subparagraph, whether the seller realized a gain or sustained a loss on the sale of the real property, or whether it can be ascertained at the time of the sale whether gain or loss occurs as a result of the sale. It is also immaterial what method of accounting the seller used in reporting gain or loss from the sale of the real property or whether at the time of reacquisition such property has depreciated or appreciated in value since the time of the original sale. Moreover, the character of the gain realized on the original sale

of the property is immaterial for purposes of applying this subparagraph. The provisions of this section shall apply, except as provided in § 1.1038–2, to the reacquisition of real property which was used by the seller as his principal residence and with respect to the sale of which an election under section 121 is in effect or with respect to the sale of which gain was not recognized under section 1034.

(2) *Sales giving rise to indebtedness*—(i) *Sale defined.* For purposes of this section, it is not necessary for title to the property to have passed to the purchaser in order to have a sale. Ordinarily, a sale of property has occurred in a transaction in which title to the property has not passed to the purchaser, if the purchaser has a contractual right to retain possession of the property so long as he performs his obligations under the contract and to obtain title to the property upon the completion of the contract. However, a sale may have occurred even if the purchaser does not have the right to possession until he partially or fully satisfies the terms of the contract. For example, if S contracts to sell real property to P, and if S promises to convey title to P upon the completion of all of the payments due under the contract and to allow P to obtain possession of the property after 10 percent of the purchase price has been paid, there has been a sale on the date of the contract for purposes of this section. This section shall not apply to a disposition of real property which constituted an exchange of property or was treated as a sale under section 121(d)(4) or section 1034(i); nor shall it apply to a sale of stock in a cooperative housing corporation described in section 121(d)(3) or section 1034(f).

(ii) *Secured indebtedness defined.* An indebtedness to the seller is secured by the real property for purposes of this section whenever the seller has the right to take title or possession of the property or both if there is a default with respect to such indebtedness. A sale of real property may give rise to an indebtedness to the seller although the seller is limited in his recourse to the property for payment of the indebtedness in the case of a default.

(3) *Reacquisitions in partial or full satisfaction of indebtedness*—(i) *Purpose of reacquisition.* This section applies only where the seller reacquires the real property in partial or full satisfaction of the indebtedness to him that arose from the sale of the real property and was secured by the property. That is, the reacquisition must be in furtherance of the seller's security rights in the property with respect to indebtedness to him that arose at the time of the sale. Accordingly, if the seller in reacquiring the real property does not pay consideration in addition to discharging the purchaser's indebtedness to him that arose from the sale and was secured by such property, this section shall apply to the reacquisition even though the purchaser has not defaulted in his obligations under the contract or such a default is not imminent. If in addition to discharging the purchaser's indebtedness to him that arose from the sale the seller pays consideration in reacquiring the real property, this section shall generally apply to the reacquisition if the reacquisition and the payment of additional consideration is provided for in the original contract for the sale of the property. This section generally shall apply to a reacquisition of real property if the seller reacquires the property either when the purchaser has defaulted in his obligations under the contract or when such a default is imminent. This section generally shall not apply to a reacquisition of real property where the seller pays consideration in addition to discharging the purchaser's indebtedness to him that arose from the sale if the reacquisition and payment of additional consideration was not provided for in the original contract for the sale of the property and if the purchaser has not defaulted in his obligations under the contract or such a default is not imminent. Thus, for example, if the purchaser is in arrears on the payment of interest or principal or has in any other way defaulted on his contract for the purchase of the property, or if the facts of the case indicate that the purchaser is unable satisfactorily to perform his obligations under the contract, and the seller reacquires the

property from the purchaser in a transaction in which the seller pays consideration in addition to discharging the purchaser's indebtedness to him that arose from the sale and was secured by the property, this section shall apply to the reacquisition. Additional consideration paid by the seller includes money and other property paid or transferred by the seller. Also, the reacquisition by the seller of real property subject to an indebtedness (or the assumption, upon the reacquisition, of indebtedness) which arose subsequent to the original sale shall be considered as a payment by the seller of additional consideration. However, the reacquisition by the seller of real property subject to an indebtedness (or the assumption, upon the reacquisition, of an indebtedness) which arose prior to or arose out of the original sale shall not be considered as a payment by the seller of additional consideration.

(ii) *Manner of reacquisition.* For purposes of applying section 1038 and this section there must be a reacquisition by the seller of the real property itself, but the manner in which the seller so reduces the property to ownership or possession, as the case may be, shall generally be immaterial. Thus, the seller may reduce the real property to ownership or possession or both, as the case may require, by agreement or by process of law. The reduction of the real property to ownership or possession by agreement includes, where valid under local law, such methods as voluntary conveyance from the purchaser and abandonment to the seller. The reduction of the real property to ownership or possession by process of law includes foreclosure proceedings in which a competitive bid is entered, such as foreclosure by judicial sale or by power of sale contained in the loan agreement without recourse to the courts, as well as those types of foreclosure proceedings in which a competitive bid is not entered, such as strict foreclosure and foreclosure by entry and possession, by writ of entry, or by publication or notice.

(4) *Persons from whom real property may be reacquired.* The real property reacquired in satisfaction of the indebtedness need not be reacquired from the purchaser but may be reacquired from the purchaser's transferee or assignee, or from a trustee holding title to such property pending the purchaser's satisfaction of the terms of the contract, so long as the indebtedness that is partially or completely satisfied in the reacquisition of such property arose in the original sale of the property and was secured by the property so reacquired. In such a case, a reference in this section to the purchaser shall, where appropriate, include the purchaser's transferee or assignee. Thus, for example, this section will apply if the seller reacquires the property from a purchaser from the original purchaser and either the property is subject to, or the subsequent purchaser assumes, the liability to the seller on the indebtedness.

(5) *Reacquisitions not included.* This section shall not apply to reacquisitions of real property by mutual savings banks, domestic building and loan associations, and cooperative banks, described in section 593(a).

(b) *Amount of gain resulting from a reacquisition*—(1) *Determination of amount*—(i) *In general.* As a result of a reacquisition to which paragraph (a) of this section applies gain shall be derived by the seller to the extent that the amount of money and the fair market value of other property (other than obligations of the purchaser arising with respect to the sale) which are received by the seller, prior to such reacquisition, with respect to the sale of the property exceed the amount of the gain derived by the seller on the sale of such property which is returned as income for periods prior to the reacquisition. However, the amount of gain so determined shall in no case exceed the amount determined under paragraph (c) of this section with respect to such reacquisition.

(ii) *Amount of gain returned as income for prior periods.* For purposes of this subparagraph and paragraph (c)(1) of this section, the amount of gain on the sale of the property which is returned as income for periods prior to the reacquisition of the real property does not include any amount of income determined under paragraph (f)(2) of this section which is considered to be received at the time of the reacquisition of the property. However, the amount

of gain on the sale of the property which is returned as income for such periods does include gain on the sale resulting from payments received in the taxable year in which the date of reacquisition occurs if such payments are received prior to such reacquisition. The application of this subdivision may be illustrated by the following example:

Example: In 1965 S, who uses the calendar year as the taxable year, sells to P for $10,000 real property which has an adjusted basis of $3,000. S properly elects under section 453 to report the income from the sale on the installment method. In 1965 and 1966, S receives a total of $4,000 on the contract. On May 15, 1967, S receives $1,000 on the contract. Because of P's default, S reacquires the property on August 31, 1967. The gain on the sale which is returned as income for periods prior to the reacquisition is $3,500 ($5,000 × $7,000/$10,000).

(2) *Amount of money and other property received with respect to the sale*—(i) *In general*. Amounts of money and other property received by the seller with respect to the sale of the property include payments made by the purchaser for the seller's benefit, as well as payments made and other property transferred directly to the seller. If the purchaser of the real property makes payments on a mortgage or other indebtedness to which the property is subject at the time of the sale of such property to him, or on which the seller was personally liable at the time of such sale, such payments are considered amounts received by the seller with respect to the sale. However, if after the sale the purchaser borrows money and uses the property as security for the loan, payments by the purchaser in satisfaction of the indebtedness are not considered as amounts received by the seller with respect to the sale, although the seller does in fact receive some indirect benefit when the purchaser makes such payments.

(ii) *Payments by purchaser at time of reacquisition*. All payments made by the purchaser at the time of the reacquisition of the real property that are with respect to the original sale of the property shall be treated, for purposes of subparagraph (1) of this paragraph, by the seller as having been received prior to the reacquisition with respect to such sale. For example, if the purchaser, at the time of the reacquisition by the seller, pays money or other property to the seller in partial or complete satisfaction of the purchaser's indebtedness on the original sale, the seller shall treat such amounts as having been received prior to the reacquisition with respect to the sale.

(iii) *Interest received*. For purposes of this subparagraph and paragraph (c)(1) of this section any amounts received by the seller as interest, stated or unstated, are excluded from the computation of gain on the sale of the property and are not considered amounts of money or other property received with respect to the sale.

(iv) *Amounts received on sale of purchaser's indebtedness*. Money or other property received by the seller on the sale of the purchaser's indebtedness that arose at the time of the sale of the real property are amounts received by the seller with respect to the sale of such real property, except that the amounts so received from the sale of such indebtedness shall be reduced by the amount of money and the fair market value of other property paid or transferred by the seller, before the reacquisition of the real property, to reacquire such indebtedness. For example, if S sells real property to P for $25,000, and under the contract receives $10,000 down and a note from P for $15,000, S would receive $22,000 with respect to the sale if he were to discount the note for $12,000. If before the reacquisition of the real property S were to reacquire the discounted note for $8,000, he would receive $14,000 with respect to the sale.

(3) *Obligations of the purchaser arising with respect to the sale*. The term *obligations of the purchaser arising with respect to the sale* of the real property includes, for purposes of subparagraph (1) of this paragraph, only that indebtedness on which the purchaser is liable to the seller and which arises out of the sale of such property. Thus, the term does not include any indebtedness in respect of the property that the seller owes to a third person which the purchaser assumes, or to which the property is subject, at the time of the sale of the property to the purchaser. Nor does the term include any indebtedness on

which the purchaser is liable to the seller if such indebtedness arises subsequent to the sale of such property.

(c) *Limitation upon amount of gain*—(1) *In general.* Except as provided by subparagraph (2) of this paragraph, the amount of gain on a reacquisition of real property, as determined under paragraph (b) of this section, shall in no case exceed—

(i) The amount by which the price at which the real property was sold exceeded its adjusted basis at the time of the sale, as determined under § 1.1011–1, reduced by

(ii) The amount of gain on the sale of such real property which is returned as income for periods prior to the reacquisition, and by

(iii) The amount of money and the fair market value of other property (other than obligations of the purchaser to the seller which are secured by the real property) paid or transferred by the seller in connection with the reacquisition of such real property.

(2) *Cases where limitation does not apply.* The limitation provided by subparagraph (1) of this paragraph shall not apply in a case where the selling price of property is indefinite in amount and cannot be ascertained at the time of the reacquisition of such property, as, for example, where the selling price is stated as a percentage of the profits to be realized from the development of the property which is sold. Moreover, the limitation so provided shall not apply to a reacquisition of real property occurring in a taxable year beginning before September 3, 1964, to which the provisions of this section are applied pursuant to an election under § 1.1038–3.

(3) *Determination of sales price.* The price at which the real property was sold shall be, for purposes of subparagraph (1) of this paragraph, the gross sales price reduced by the selling commissions, legal fees, and other expenses incident to the sale of such property which are properly taken into account in determining gain or loss on the sale. For example, the amount of selling commissions paid by a nondealer will be deducted from the gross sales price in determining the price at which the real property was sold; on the other hand, selling commissions paid by a real estate dealer will be deducted as a business expense. Examples of other expenses incident to the sale of the property are expenses for appraisal fees, advertising expense, cost of preparing maps, recording fees, and documentary stamp taxes. Payments on indebtedness to the seller which are for interest, stated or unstated, are not included in determining the price at which the property was sold. See paragraph (b)(2)(iii) of this section.

(4) *Determination of amounts paid or transferred in connection with a reacquisition*—(i) *In general.* Amounts of money or property paid or transferred by the seller of the real property in connection with the reacquisition of such property include payments of money, or transfers of property, to persons from whom the real property is reacquired as well as to other persons. Payments or transfers in connection with the reacquisition of the property do not include money or property paid or transferred by the seller to reacquire obligations of the purchaser to the seller which were received by the seller with respect to the sale of the property or which arose subsequent to the sale. Amounts of money or property paid or transferred by the seller in connection with the reacquisition of the property include payments or transfers for such items as court costs and fees for services of an attorney, master, trustee, or auctioneer, or for publication, acquiring title, clearing liens, or filing and recording.

(ii) *Assumption of indebtedness.* The assumption by the seller, upon reacquisition of the real property, of any indebtedness to another person which at such time is secured by such property will be considered a payment of money by the seller in connection with the reacquisition. Also, if at the time of reacquisition such property is subject to an indebtedness which is not an indebtedness of the purchaser to the seller, the seller shall be considered to have paid money, in an amount equal to such indebtedness, in connection with the reacquisition of the property. Thus, for example, if at the time of the sale the purchaser executes in connection with the sale a first mortgage to a bank and a second mortgage to the seller and at

the time of reacquisition the seller reacquires the property subject to the first mortgage which he does not assume, the seller will be considered to have paid money, in an amount equal to the unpaid amount of the first mortgage, in connection with the reacquisition.

(d) *Character of gain resulting from a reacquisition*. Paragraphs (b) and (c) of this section set forth the extent to which gain shall be derived from a reacquisition to which paragraph (a) of this section applies, but the rule provided by section 1038 and this section do not affect the character of the gain so derived. The character of the gain resulting from such a reacquisition is determined on the basis of whether the gain on the original sale was returned on the installment method or, if not, on the basis of whether title to the real property was transferred to the purchaser; and, if title was transferred to the purchaser in a deferred-payment sale, whether the reconveyance of the property to the seller was voluntary. For example, if the gain on the original sale of the reacquired property was returned on the installment method, the character of the gain on reacquisition by the seller shall be determined in accordance with the rules provided in paragraph (a) of § 1.453–9. If the original sale was not on the installment method but was a deferred-payment sale, as described in § 1.453–6(a), where title to the real property was transferred to the purchaser and the seller accepts a voluntary reconveyance of the property, the gain on the reacquisition shall be ordinary income; however, if the obligations satisfied are securities (as defined in section 165(g)(2)(C)), any gain resulting from the reacquisition is capital gain subject to the provisions of subchapter P of chapter 1 of the Code.

(e) *Recognition of gain*. The entire amount of the gain determined under paragraphs (b) and (c) of this section with respect to a reacquisition to which paragraph (a) of this section applies shall be recognized notwithstanding any other provisions of subtitle A (relating to income taxes) of the Code.

(f) *Special rules applicable to worthless indebtedness*—(1) *Worthlessness resulting from reacquisition*. No debt of the purchaser to the seller which was secured by the reacquired real property shall be considered as becoming worthless or partially worthless as a result of a reacquisition of such real property to which paragraph (a) of this section applies. Accordingly, no deduction for a bad debt and no charge against a reserve for bad debts shall be allowed, as a result of the reacquisition, in order to reflect the noncollectibility of any indebtedness of the purchaser to the seller which at the time of reacquisition was secured by such real property.

(2) *Indebtedness treated as worthless prior to reacquisition*—(i) *Prior taxable years*. If for any taxable year ending before the taxable year in which occurs a reacquisition of real property to which paragraph (a) of this section applies the seller of such property has treated any indebtedness of the purchaser which is secured by such property as having become worthless or partially worthless by taking a bad debt deduction under section 166(a), he shall be considered as receiving, at the time of such reacquisition, income in an amount equal to the amount of such indebtedness previously treated by him as having become worthless. The amount so treated as income received shall be treated as a recovery of a bad debt previously deducted as worthless or partially worthless. Accordingly, the amount of such income shall be excluded from gross income, as provided in § 1.111–1, to the extent of the *recovery exclusion* with respect to such item. For purposes of § 1.111–1, if the indebtedness was treated as partially worthless in a prior taxable year, the amount treated under this subparagraph as a recovery shall be considered to be with respect to the part of the indebtedness that was previously deducted as worthless. The seller shall not be considered to have treated an indebtedness as worthless in any taxable year for which he took the standard deduction under section 141 or paid the tax imposed by section 3 if a deduction in respect of such indebtedness was not allowed in determining adjusted gross income for such year under section 62.

(ii) *Current taxable year*. No deduction shall be allowed under section 166 (a), for the taxable year in which occurs a reacquisition of real property to which

paragraph (a) of this section applies, in respect of any indebtedness of the purchaser secured by such property which has been treated by the seller as having become worthless or partially worthless in such taxable year but prior to the date of such reacquisition.

(3) *Basis adjustment*. The basis of any indebtedness described in subparagraph (2)(i) of this paragraph shall be increased (as of the date of the reacquisition) by an amount equal to the amount which, under such subparagraph of this paragraph, is treated as income received by the seller with respect to such indebtedness, but only to the extent the amount so treated as received is not excluded from gross income by reason of the application of § 1.111–1.

(g) *Rules for determining gain or loss on disposition of reacquired property*—(1) *Basis of reacquired real property*. The basis of any real property acquired in a reacquisition to which paragraph (a) of this section applies shall be the sum of the following amounts, determined as of the date of such reacquisition:

(i) The amount of the adjusted basis, determined under sections 453 and 1011, and the regulations thereunder, of all indebtedness of the purchaser to the seller which at the time of reacquisition was secured by such property, including any increase by reason of paragraph (f)(3) of this section,

(ii) The amount of gain determined under paragraphs (b) and (c) of this section with respect to such reacquisition, and

(iii) The amount of money and the fair market value of other property (other than obligations of the purchaser to the seller which are secured by the real property) paid or transferred by the seller in connection with the reacquisition of such real property, determined as provided in paragraph (c) of this section even though such paragraph does not apply to the reacquisition.

(2) *Basis of undischarged indebtedness*. The basis of any indebtedness of the purchaser to the seller which was secured by the reacquired real property described in subparagraph (1) of this paragraph, to the extent that such indebtedness is not discharged upon the reacquisition of such property, shall be zero. Therefore, to the extent not discharged upon the reacquisition of the real property, indebtedness on the original obligation of the purchaser, a substituted obligation of the purchaser, a deficiency judgment entered in a court of law into which the purchaser's obligation has merged, or any other obligation of the purchaser to the seller, shall be zero if such indebtedness constitutes an indebtedness to the seller which was secured by such property.

(3) *Holding period of reacquired property*. Since the reacquisition described in subparagraph (1) of this paragraph is in a sense considered a nullification of the original sale of the real property, for purposes of determining gain or loss on a disposition of such property after its reacquisition the period for which the seller has held the real property at the time of such disposition shall include the period for which such property is held by him prior to the original sale. However, the holding period shall not include the period of time commencing with the date following the date on which the property is originally sold to the purchaser and ending with the date on which the property is reacquired by the seller. The period for which the property was held by the seller prior to the original sale shall be determined as provided in § 1.1223–1. For example, if under paragraph (a) of § 1.1223–1 real property, which was acquired as the result of an involuntary conversion, has been held for five months on January 1, 1965, the date of its sale, and such property is reacquired on July 2, 1965, and resold on July 3, 1965, the seller will be considered to have held such property for five months and one day for purposes of this subparagraph.

(h) *Illustrations*. The application of this section may be illustrated by the following examples in which it is assumed that the reacquisition is in satisfaction of secured indebtedness arising out of the sale of the real property:

Example 1. (a) S purchases real property for $20 and sells it to P for $100, the property not being mortgaged at the time of sale. Under the contract P pays $10 down and executes a note for $90, with stated interest at 6 percent, to be paid in nine annual installments. S properly elects to report the gain on the

installment method. After the second $10 annual payment P defaults and S accepts a voluntary reconveyance of the property in complete satisfaction of the indebtedness. S pays $5 in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is $110.

(b) The gain derived by S on the reacquisition of the property is $6, determined as follows:

Gain before application of limitation:		
Money with respect to the sale received by S prior to the reacquisition		$30
Less: Gain returned by S as income for periods prior to the reacquisition ($30 × [($100 − $20)/$100])		24
Gain before application of limitation		6
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at the time of sale	$20	
Gain returned by S as income for periods prior to the reacquisition	24	
Amount of money paid by S in connection with the reacquisition	5	49
Limitation on amount of gain		51
Gain resulting from the reacquisition of the property		6

(c) The basis of the reacquired real property at the date of the reacquisition is $25, determined as follows:

Adjusted basis of P's indebtedness to S ($70 − [$70 × $80/$100])	$14
Gain resulting from the reacquisition of the property	6
Amount of money paid by S in connection with the reacquisition	5
Basis of reacquired property	25

Example 2. (a) The facts are the same as in example (1) except that S purchased the property for $80.

(b) The gain derived by S on the reacquisition of the property is $9, determined as follows:

Gain before application of limitation:		
Money with respect to the sale received by S prior to the reacquisition		$30
Less: Gain returned by S as income for periods prior to the reacquisition ($30 × [($100 − $80)/$100])		$6
Gain before application of limitation		24
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at the time of sale	$80	
Gain returned by S as income for periods prior to the reacquisition	6	
Amount of money paid by S in connection with the reacquisition	5	91
Limitation on amount of gain		9
Gain resulting from the reacquisition of the property		9

(c) The basis of the reacquired real property at the date of the reacquisition is $70, determined as follows:

Adjusted basis of P's indebtedness to S ($70 − [$70 × $20/$100])	$56
Gain resulting from the reacquisition of the property	9
Amount of money paid by S in connection with the reacquisition	5
Basis of reacquired property	70

Example 3. (a) S purchases real property for $70 and sells it to P for $100, the property not being mortgaged at the time of sale. Under the contract P pays $10 down and executes a note for $90, with stated interest at 6 percent, to be paid in nine annual installments. S properly elects to report the gain on the installment method. After the first $10 annual payment P defaults and S accepts a voluntary reconveyance of the property in complete satisfaction of the indebtedness. S pays $5 in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is $50.

(b) The gain derived by S on the reacquisition of the property is $14, determined as follows:

Gain before application of limitation:		
Money with respect to the sale received by S prior to the reacquisition		$20
Less: Gain returned by S as income for periods prior to the reacquisition ($20 × [($100 − $70)/$100])		6
Gain before application of limitation		14
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at time of sale	$70	
Gain returned by S as income for periods prior to the reacquisition	6	
Amount paid by S in connection with the reacquisition	5	81
Limitation on amount of gain		19
Gain resulting from the reacquisition of the property		14

(c) The basis of the reacquired real property at the date of the reacquisition is $75, determined as follows:

Adjusted basis of P's indebtedness to S ($80 − [$80 × $30/$100])	$56
Gain resulting from the reacquisition of the property	14

Amount of money paid by S in connection with the reacquisition	5
Basis of reacquired property	75

Example 4. (a) S purchases real property for $20 and sells it to P for $100, the property not being mortgaged at the time of sale. Under the contract P pays $10 down and executes a note for $90, with stated interest at 6 percent, to be paid in nine annual installments. S properly elects to report gain on the installment method. After the second $10 annual payment P defaults and S accepts from P in complete satisfaction of the indebtedness a voluntary reconveyance of the property plus cash in the amount of $20. S does not pay any amount in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is $30.

(b) The gain derived by S on the reacquisition of the property is $10, determined as follows:

Gain before application of the limitation:		
Money with respect to the sale received by S prior to the reacquisition ($30 + $20)		$50
Less: Gain returned by S as income for periods prior to the reacquisition ($50 × [($100 − $20)/$100])		40
Gain before application of limitation		10
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at time of sale	$20	
Gain returned by S as income for periods prior to the reacquisition	40	60
Limitation on amount of gain		40
Gain resulting from the reacquisition of the property		10

(c) The basis of the reacquired real property at the date of the reacquisition is $20, determined as follows:

Adjusted basis of P's indebtedness to S ($50 − [$50 × $80/$100])	$10
Gain resulting from the reacquisition of the property	10
Basis of reacquired property	20

Example 5. (a) S purchases real property for $80 and sells it to P for $100, the property not being mortgaged at the time of sale. Under the contract P pays $10 down and executes a note for $90, with stated interest at 6 percent, to be paid in nine annual installments. At the time of sale P's note has a fair market value of $90. S does not elect to report the gain on the installment method but treats the transaction as a deferred-payment sale. After the third $10 annual payment P defaults and S forecloses. Under the foreclosure sale S bids in the property at $70, cancels P's obligation of $60, and pays $10 to P. There are no other amounts paid by S in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is $70.

(b) The gain derived by S on the reacquisition of the property is $0, determined as follows:

Gain before application of the limitation:		
Money with respect to the sale received by S prior to the reacquisition		$40
Less: Gain returned by S as income for periods prior to the reacquisition ([$10 + $90] − $80)		20
Gain before application of limitation		20
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at the time of sale	$80	
Gain returned by S as income for periods prior to the reacquisition	20	
Amount of money paid by S in connection with the reacquisition	10	110
Limitation on amount of gain (not to be less than zero)		0
Gain resulting from the reacquisition of the property		0

(c) The basis of the reacquired real property at the date of the reacquisition is $70, determined as follows:

Adjusted basis of P's indebtedness to S (face value at time of reacquisition)	$60
Gain resulting from the reacquisition of the property	0
Amount of money paid by S in connection with the reacquisition	10
Basis of reacquired property	70

[T.D. 6916, 32 FR 5925, Apr. 13, 1967; 32 FR 6971, May 6, 1967; T.D. 9849, 84 FR 9237, Mar. 14, 2019]

§ 1.1038–2 Reacquisition and resale of property used as a principal residence.

(a) *Application of special rules*—(1) *In general.* If paragraph (a) of § 1.1038–1 applies to the reacquisition of real property which was used by the seller as his principal residence and with respect to the sale of which an election under section 121 is in effect or with respect to the sale of which gain was not recognized under section 1034, the provisions of § 1.1038–1 (other than paragraph (a) thereof) shall not, and this section shall, apply to the reacquisition of such property if the property is resold by the seller within one year after the date of the reacquisition. For purposes

of this section an election under section 121 shall be considered to be in effect with respect to the sale of the property if, at the close of the last day for making such an election under section 121(c) with respect to such sale, an election under section 121 has been made and not revoked. Thus, a taxpayer who properly elects, subsequent to the reacquisition, to have section 121 apply to a sale of his residence may be eligible for the treatment provided in this section. The treatment provided by this section is mandatory; however, see §1.1038–3 for an election to apply the provisions of this section to certain taxable years beginning after December 31, 1957.

(2) *Sale and resale treated as one transaction.* In the case of a reacquisition to which this section applies, the resale of the reacquired property shall be treated, for purposes of applying sections 121 and 1034, as part of the transaction constituting the original sale of such property. In effect, the reacquisition is generally disregarded pursuant to this section and, for purposes of applying sections 121 and 1034, the resale of the property is considered to constitute a sale of such property occurring on the date of the original sale of such property.

(b) *Transactions not included.* (1) If with respect to the original sale of the property there was no nonrecognition of gain under section 1034 and an election under section 121 is not in effect, the provisions of §1.1038–1, and not this section, shall apply to the reacquisition. Thus, for example, if in the case of a taxpayer not entitled to the benefit of section 121 there is no gain on the original sale of the property, the provisions of §1.1038–1, and not this section, shall apply even though a redetermination of gain under this section would result in the nonrecognition of gain on the sale under section 1034. Also, if in the case of such a taxpayer there was gain on the original sale of the property but after the application of section 1034 all of such gain was recognized, the provisions of §1.1038–1, and not this section, shall apply to the reacquisition.

(2) If the original sale of the property was not eligible for the treatment provided by section 121 and section 1034, the provisions of §1.1038–1, and not this section, shall apply to the reacquisition of the property even though the resale of such property is eligible for the treatment provided by either or both of sections 121 and 1034.

(c) *Redetermination of gain required*—(1) *Sale of old residence.* The amount of gain excluded under section 121 on the sale of the property and the amount of gain recognized under section 1034 on the sale of the property shall be redetermined under this section by recomputing the adjusted sales price and the adjusted basis of the property, and any adjustments resulting from the redetermination of the gain on the sale of such property shall be reflected in the income of the seller for his taxable year in which the resale of the property occurs.

(2) *Sale of new residence.* If gain was not recognized under section 1034 on the original sale of the property, the adjusted basis of the new residence shall be redetermined under this section. If the new residence has been sold, the amount of gain returned on such sale of the new residence which is affected by the redetermination of the recognized gain on the sale of the old residence shall be redetermined under this section, and any adjustments resulting from the redetermination of the gain on the sale of the new residence shall be reflected in income of the seller for his taxable year in which the resale of the old residence occurs.

(d) *Redetermination of adjusted sales price.* For purposes of applying sections 121 and 1034 pursuant to this section, the adjusted sales price of the reacquired real property shall be redetermined by taking into account both the sale and the resale of the property and shall be—

(1) The amount realized, which for purposes of section 1001 shall be—

(i) The amount realized on the resale of the property, as determined under paragraph (b)(4) of §1.1034–1, plus

(ii) The amount realized on the original sale of the property, determined as provided in paragraph (b)(4) of §1.1034–1, less that portion of any obligations of the purchaser arising with respect to such sale which at the time of reacquisition is secured by such property and is unpaid, less

(iii) The amount of money and the fair market value of other property (other than obligations of the purchaser to the seller secured by the real property) paid or transferred by the seller in connection with the reacquisition of such real property,

reduced by

(2) The total of the fixing-up expenses (as defined in par. (b)(6) of § 1.1034–1) incurred for work performed on such real property to assist in both its original sale and its resale.

For purposes of applying paragraph (b)(6) of § 1.1034–1, there shall be two 90-day periods, the first ending on the day on which the contract to sell is entered into in connection with the original sale of the property, and the second ending on the day on which the contract to sell is entered into in connection with the resale of the property. There shall also be two 30-day periods for such purposes, the first ending on the 30th day after the date of the original sale, and the second ending on the 30th day after the date of the resale. For determination of the obligations of the purchaser arising with respect to the original sale of the property, see paragraph (b)(3) of § 1.1038–1. For determination of amounts paid or transferred by the seller in connection with the reacquisition of the property, see paragraph (c)(4) of § 1.1038–1.

(e) *Determination of adjusted basis at time of resale.* For purposes of applying sections 121 and 1034 pursuant to this section, the adjusted basis of the reacquired real property at the time of its resale shall be—

(1) The sum of—

(i) The adjusted basis of such property at the time of the original sale, with proper adjustment under section 1016(a) in respect of such property for the period occurring after the reacquisition of such property, and

(ii) Any indebtedness of the purchaser to the seller which arose subsequent to the original sale of such property and which at the time of reacquisition was secured by such property,

reduced by

(2) Any indebtedness of the purchaser to the seller which at the time of reacquisition was secured by the reacquired real property and which, for any taxable year ending before the taxable year in which occurs the reacquisition to the seller which was secured by the seller as having become worthless or partially worthless by taking a bad debt deduction under section 166(a).

The reduction under the preceding sentence by reason of having treated indebtedness as worthless or partially worthless shall not exceed the amount by which there would be an increase in the basis of such indebtedness under paragraph (f)(3) of § 1.1038–1 if section 1038(d) had been applicable to the reacquisition of such property.

(f) *Treatment of indebtedness secured by the property*—(1) *Year of reacquisition.* No debt of the purchaser to the seller which was secured by the reacquired real property shall be considered as becoming worthless or partially worthless as a result of a reacquisition of such real property to which this section applies. Accordingly, no deduction for a bad debt shall be allowed, as a result of the reacquisition, in order to reflect the noncollectibility of any indebtedness of the purchaser to the seller which at the time of reacquisition was secured by such real property. In addition, no deduction shall be allowed, for the taxable year in which occurs a reacquisition of real property to which this section applies, in respect of any indebtedness of the purchaser secured by such property which has been treated by the seller as having become worthless or partially worthless in such taxable year but prior to the date of such reacquisition.

(2) *Prior taxable years.* For reduction of the basis of the real property for indebtedness treated as worthless or partially worthless for taxable years ending before the taxable year in which occurs the reacquisition, see paragraph (e) of this section.

(3) *Basis of indebtedness.* The basis of any indebtedness of the purchaser to the seller which was secured by the reacquired real property, to the extent that such indebtedness is not discharged upon the reacquisition of such property, shall be zero.

(g) *Date of sale.* Since the resale of the property, by being treated as part of the transaction constituting the original sale of the property, is treated as having occurred on the date of the

original sale, in determining whether any of the time requirements of section 121 or section 1034 are satisfied for purposes of this section the date of the original sale is used, except to the extent provided in paragraph (d)(2) of this section.

(h) *Illustrations*. The application of this section may be illustrated by the following examples:

Example 1. (a) On June 30, 1964, S, a single individual over 65 years of age, sells his principal residence to P for $25,000, the property not being mortgaged at the time of sale. S properly elects to apply the provisions of section 121 to the sale. Under the contract, P pays $5,000 down and executes a note for $20,000 with stated interest at 6 percent, the principal being payable in installments of $5,000 each on January 1 of each year and the note being secured by the real property which is sold. At the time of sale P's note has a fair market value of $20,000. S does not elect to report the gain on the installment method but treats the transaction as a deferred-payment sale, title to the property being transferred to P at the time of sale. S uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting. After making two annual payments of $5,000 each on the note, P defaults on the contract, and on March 1, 1967, S reacquires the real property in full satisfaction of P's indebtedness, title to the property being voluntarily reconveyed to S. On November 1, 1967, S sells the property to T for $35,000. The assumption is made that no fixing-up expenses are incurred for work performed on the principal residence in order to assist in the sale of the property in 1964 or in the resale of the property in 1967. At the time of sale in 1964 the property has an adjusted basis of $15,000. S does not treat any indebtedness with respect to the sale in 1964 as being worthless or partially worthless or make any capital expenditures with respect to the property after such sale. In his return for 1964, S includes in income $2,000 capital gain from the sale of his residence.

(b) The results obtained before and after the reacquisition of the property are as follows:

	Before reacquisition	After reacquisition
Adjusted sales price:		
$5,000 + $20,000	$25,000	.....
$15,000 + $35,000	.....	$50,000
Less: Adjusted basis of property at time of sale	15,000	15,000
Gain on sale	10,000	35,000
Gain excluded from income under section 121:.		
$10,000 × $20,000/$25,000	8,000	.....
$35,000 × $20,000/$50,000	.....	14,000
Gain included in income after applying section 121:		
$10,000 − $8,000	2,000	.....
$35,000 − $14,000	.....	21,000

(c) S is required to show the additional inclusion of $19,000 capital gain ($21,000 − $2,000) in income on his return for 1967.

Example 2. (a) The facts are the same as in example (1) except that on April 1, 1965, S purchases a new residence at a cost of $30,000 and qualifies for the nonrecognition of gain under section 1034 in respect of the sale of his principal residence on June 30, 1964. In his return for 1964, S does not include any capital gain in income as a result of the sale of the old residence.

(b) The results obtained before and after the reacquisition of the property are as follows:

	Before reacquisition	After reacquisition
Application of section 121 (see example (1)):		
Adjusted sales price	$25,000	$50,000
Less: Adjusted basis of property at time of sale	15,000	15,000
Gain on sale	10,000	35,000
Gain excluded from income under section 121	8,000	14,000
Gain not excluded from income under section 121	2,000	21,000
Application of section 1034: Adjusted sales price:		
$25,000 − $8,000	17,000	.....
$50,000 − $14,000	.....	36,000
Less: Cost of new residence	30,000	30,000
Gain recognized under section 1034 on sale of old residence	0	6,000
Gain not recognized under section 1034 on sale of old residence:		
($10,000 − [$8,000 + $0])	2,000	.....
($35,000 − [$14,000 + $6,000])	.....	15,000
Adjusted basis of new residence on April 1, 1965:		
$30,000 − $2,000	28,000	.....
$30,000 − $15,000	.....	15,000

(c) The $6,000 of capital gain on the sale of the old residence is required to be included in income on the return for 1967. The adjusted basis on April 1, 1965, for determining gain on a sale or exchange of the new residence at any time on or after that date is $15,000, after taking into account the reacquisition and resale of the old residence.

Example 3. The facts are the same as in example (2) except that S sells the new residence on June 20, 1965, for $40,000 and includes $12,000 of capital gain ($40,000 −

$28,000) on its sale in his income on the return for 1965. S is required to include the additional capital gain of $13,000 ([$40,000 − $15,000] − $12,000) on the sale of the new residence in his income on the return for 1967. For this purpose, the assumption is also made that there are no additional adjustments to the basis of the new residence after April 1, 1965.

[T.D. 6916, 32 FR 5929, Apr. 13, 1967; 32 FR 6971, May 6, 1967]

§ 1.1038–3 Election to have section 1038 apply for taxable years beginning after December 31, 1957.

(a) *In general.* If an election is made in the manner provided by paragraph (b) of this section, the applicable provisions of §§ 1.1038–1 and 1.1038–2 shall apply to all reacquisitions of real property occurring in each and every taxable year beginning after December 31, 1957, and before September 3, 1964, for which the assessment of a deficiency, or the credit or refund of an overpayment, is not prevented on September 2, 1964, by the operation of any law or rule of law. The election so made shall apply to all taxable years beginning after December 31, 1957, and before September 3, 1964, for which the assessment of a deficiency, or the credit or refund of an overpayment, is not prevented on September 2, 1964, by the operation of any law or rule of law and shall apply to every reacquisition occurring in such taxable years. The fact that the assessment of a deficiency, or the credit or refund of an overpayment, is prevented for any other taxable year or years affected by the election will not prohibit the making of an election under this section. For example, if an individual who uses the calendar year as the taxable year were to sell in 1960 real property used as his principal residence in respect of the sale of which gain is not recognized under section 1034, and if such property were reacquired by the seller in 1962 and resold within 1 year, he would be permitted to make an election under this section with respect to such reacquisition even though on September 2, 1964, the period of limitations on assessment or refund has run for 1960. An election under this section shall be deemed a consent to the application of the provisions of this section.

(b) *Time and manner of making election*—(1) *In general.* (i) An election to have the provisions of § 1.1038–2 apply to reacquisitions of real property occurring in taxable years beginning after December 31, 1957, and before September 3, 1964, shall be made by filing on or before September 3, 1965, a return, an amended return, or a claim for refund, whichever is proper, for each taxable year in which the resale of such real property occurs. If the return for any such year is not due on or before such date and has not been filed, the election with respect to such taxable year shall be made by filing on or before such date the statement described in subparagraph (2) of this paragraph.

(ii) An election to have the provisions of § 1.1038–1 apply to reacquisitions of real property occurring in taxable years beginning after December 31, 1957, and before September 3, 1964, shall be made by filing on or before September 3, 1965, a return, an amended return, or a claim for refund, whichever is proper, for each taxable year in which such reacquisitions occur. If the return for any such year is not due on or before such date and has not been filed, the election with respect to such taxable year shall be made by filing on or before such date the statement described in subparagraph (2) of this paragraph.

(iii) If the facts are such that § 1.1038–2 applies to a reacquisition of property except that the reacquisition occurs in a taxable year beginning after December 31, 1957, and before September 3, 1964, an election may not be made under this paragraph to have the provisions of § 1.1038–1 apply to such reacquisition.

(iv) Once made, an election under this paragraph may not be revoked after September 3, 1965. To any return, amended return, or claim for refund filed under this subparagraph there shall be attached the statement described in subparagraph (2) of this paragraph.

(2) *Statement to be attached.* The statement described in subparagraph (1) of this paragraph shall indicate—

(i) The name, address and account number of the taxpayer, and the fact that the taxpayer is electing to have

the provisions of section 1038 apply to the reacquisitions of real property,

(ii) The taxable years in which the reacquisitions of property occur and any other taxable year or years the tax for which is affected by the application of section 1038 to such reacquisitions,

(iii) The office of the district director where the return or returns for such taxable year or years were or will be filed,

(iv) The dates on which such return or returns were filed and on which the tax for such taxable year or years was paid,

(v) The type of real property reacquired, the terms under which such property was sold and reacquired, and an indication of whether the taxpayer is applying the provisions of § 1.1038–2 to the reacquisition of such property,

(vi) If § 1.1038–2 is being applied to the reacquisition, the terms under which the old residence was resold and, if applicable, the terms under which the new residence was sold, and

(vii) The office where, and the date when, the election to apply section 121 in respect to any sale of such property was or will be made.

(3) *Place for filing*. Any claim for refund, amended return, or statement, filed under this paragraph in respect of any taxable year, whether the taxable year in which occurs the reacquisition of property or the taxable year in which occurs the resale of the old residence, shall be filed in the office of the district director in which the return for such taxable year was or will be filed.

(c) *Extension of period of limitations on assessment or refund*—(1) *Assessment of tax*. If an election is properly made under paragraph (b) of this section and the assessment of a deficiency for the taxable years to which such election applies is not prevented on September 2, 1964, by the operation of any law or rule of law, the period within which a deficiency for such taxable years may be assessed shall, to the extent such deficiency is attributable to the application of section 1038, not expire prior to one year after the date on which such election is made.

(2) *Refund of tax*. If an election is properly made under paragraph (b) of this section and the credit or refund of any overpayment for the taxable years to which such election applies is not prevented on September 2, 1964, by the operation of any law or rule of law, the period within which a claim for credit or refund of an overpayment for such taxable years may be filed shall, to the extent such overpayment is attributable to the application of section 1038, not expire prior to one year after the date on which such election is made.

(d) *Payment of interest for period prior to September 2, 1964*. No interest shall be payable with respect to any deficiency attributable to the application of the provisions of section 1038, and no interest shall be allowed with respect to any credit or refund of any overpayment attributable to the application of such section, for any period prior to September 2, 1964. See section 2(c)(3) of the Act of September 2, 1964 (Pub. L. 88–750, 78 Stat. 856).

[T.D. 6916, 32 FR 5930, Apr. 13, 1967]

§ 1.1039–1 Certain sales of low-income housing projects.

(a) *Nonrecognition of gain*. Section 1039 provides rules under which the taxpayer may elect not to recognize gain in certain cases where a qualified housing project is sold or disposed of after October 9, 1969, in an approved disposition and another such qualified housing project or projects (referred to as the *replacement project*) is acquired, constructed, or reconstructed within a specified reinvestment period. If the requirements of section 1039 are met, and if the taxpayer makes an election in accordance with the provisions of paragraph (b)(4) of this section, then the gain realized upon the sale or disposition is recognized only to the extent that the net amount realized on such sale or disposition exceeds the cost of the replacement project. However, notwithstanding section 1039, gain may be recognized by reason of the application of section 1245 or 1250 to the sale or disposition. (See § 1.1245–6(b) and § 1.1250–3(h). The terms *qualified housing project*, *approved disposition*, *reinvestment period*, and *net amount realized* are defined in paragraph (c) of this section.

(b) *Rules of application*—(1) *In general*. The election under section 1039(a) may be made only by the taxpayer owning

the qualified housing project disposed of. Thus, if the qualified housing project disposed of is owned by a partnership, the partnership must make the election. (See section 703(b).) Similarly, if the qualified housing project disposed of is owned by a corporation or trust, the corporation or trust must make the election. In addition, the reinvestment of the taxpayer must be in such a manner that the taxpayer would be entitled to a deduction for depreciation on the replacement project. Thus, if the qualified housing project disposed of is owned by individual A, the purchase by A of stock in a corporation owning or constructing such a project or of an interest in a partnership owning or constructing such a project will not be considered as the purchase or construction by A of such a project.

(2) *Special rules.* (i) The cost of a replacement project acquired before the approved disposition of a qualified housing project shall be taken into account under section 1039 only if such property is held by the taxpayer on the date of the approved disposition.

(ii) Except as provided in section 1039 (d), no property acquired by the taxpayer shall be taken into account for purposes of section 1039(a)(2) unless the unadjusted basis of such property is its cost within the meaning of section 1012. For example, if a qualified housing project is acquired in an exchange under section 1031, relating to exchange of property held for productive use or investment, such property will not be taken into account under section 1039(a)(2) because its basis is determined by reference to the basis of the property exchanged. (See section 1031(d).)

(3) *Cost of replacement project.* The taxpayer's cost for the replacement project includes only amounts properly treated as capital expenditures by the taxpayer that are attributable to acquisition, construction, or reconstruction made within the reinvestment period (as defined in paragraph (c)(4) of this section). See section 263 for rules as to what constitutes capital expenditures. Thus, assume that a calendar year taxpayer realizes gain in 1970 upon the approved disposition of a qualified housing project occurring on January 1, 1970. If the taxpayer had begun construction of another qualified housing project on January 1, 1969, and completes such construction on June 1, 1972, only that portion of the cost attributable to the period before January 1, 1972, constitutes the cost of the replacement project for purposes of section 1039. For purposes of determining the cost of a replacement project attributable to a particular period, the total cost of the project may be allocated to such period on the basis of the portion of the total project actually constructed during such period.

(4) *Election.* (i) An election not to recognize the gain realized upon an approved disposition of a qualified housing project to the extent provided in section 1039(a) may be made by attaching a statement to the income tax return filed for the first taxable year in which any portion of the gain on such disposition is realized. Such a statement shall contain the information required by subdivision (iii) of this subparagraph. If the taxpayer does not file such a statement for the first taxable year in which any portion of the gain is realized, but fails to report a portion of the gain realized upon the approved disposition as income for such year or for any subsequent taxable year, then an election shall be deemed to be made under section 1039 (a) with respect to that portion of the gain not reported as income.

(ii) An election may be made under section 1039(a) even though the replacement project has not been acquired or constructed at the time of election. However, if an election has been made and (*a*) a replacement project is not constructed, reconstructed, or acquired, (*b*) the cost of the replacement project is lower than the net amount realized from the approved disposition, or (*c*) a decision is made not to construct, reconstruct, or acquire a replacement project, then the tax liability for the year or years for which the election was made shall be recomputed and an amended return filed. An election may be made even though the taxpayer has filed his return and recognized gain upon the disposition provided that the period of limitation on filing claims for credit or refund prescribed by section 6511 has not expired. In such case, a statement containing

the information required by subdivision (iii) of this subparagraph should be filed together with a claim for credit or refund for the taxable year or years in which gain was recognized.

(iii) The statement referred to in subdivisions (i) and (ii) of this subparagraph shall contain the following information:

(*a*) The date of the approved disposition;

(*b*) If a replacement project has been acquired, the date of acquisition and cost of the project;

(*c*) If a replacement project has been constructed or reconstructed by or for the taxpayer, the date construction was begun, the date construction was completed, and the percentage of construction completed within the reinvestment period;

(*d*) If no replacement project has been constructed, reconstructed, or acquired prior to the time of filing of the statement, the estimated cost of such construction, reconstruction, or acquisition;

(*e*) The adjusted basis of the project disposed of; and

(*f*) The amount realized upon the approved disposition and a description of the expenses directly connected with the disposition and the taxes (other than income taxes) attributable to the disposition.

(c) *Definitions*—(1) *General*. The definitions contained in subparagraphs (2) through (5) of this paragraph shall apply for purposes of this section.

(2) *Qualified housing project*. The term *qualified housing project* means a rental or cooperative housing project for lower income families that has been constructed, reconstructed, or rehabilitated pursuant to a mortgage which is insured under section 221(d)(3) or 236 of the National Housing Act, provided that with respect to the housing project disposed of and the replacement project constructed, reconstructed, or acquired, the owner of the project at the time of the approved disposition and prior to the close of the reinvestment period is, under such sections or regulations issued thereunder,

(i) Limited as to rate of return on his investment in the project, and

(ii) Limited as to rentals or occupancy charges for units in the project. If the owner of the project is organized and operated as a nonprofit cooperative or other nonprofit organization, then such owner shall be considered to meet the requirement of subdivision (i) of this subparagraph.

(3) *Approved disposition*. The term *approved disposition* means a sale or other disposition of a qualified housing project to the tenants or occupants of units in such project, or to a nonprofit cooperative or other nonprofit organization formed and operated solely for the benefit of such tenants or occupants, provided that it is approved by the Secretary of Housing and Urban Development or his delegate under section 221 (d)(3) or 236 of the National Housing Act or regulations issued under such sections. Evidence of such approval should be attached to the tax return or statement in which the election under section 1039 is made.

(4) *Reinvestment period*. (i) The term *reinvestment period* means the period beginning 1 year before the date of the disposition and ending 1 year after the close of the first taxable year in which any part of the gain from such disposition is realized, or at such later date as may be designated pursuant to an application made by the taxpayer. Such application shall be made before the expiration of one year after the close of the first taxable year in which any part of the gain from such disposition is realized, unless the taxpayer can show to the satisfaction of the district director that—

(*a*) Reasonable cause exists for not having filed the application within the required period, and

(*b*) The filing of such application was made within a reasonable time after the expiration of the required period.

The application shall contain all the information required by paragraph (b)(4) of this section and shall be made to the district director for the internal revenue district in which the return is filed for the first taxable year in which any of the gain from the approved disposition is realized.

(ii) Ordinarily, requests for extension of the reinvestment period will not be granted until near the end of such period and any extension will usually be limited to a period not exceeding one

year. Although granting of an extension depends upon the facts and circumstances of a particular case, if a predominant portion of the construction of the replacement project has been completed or is reasonably expected to be completed within the reinvestment period (determined without regard to any extension thereof), an extension of the reinvestment period will ordinarily be granted. The fact that there is a scarcity of replacement property for acquisition will not be considered sufficient grounds for granting an extension.

(5) *Net amount realized.* (i) The *net amount realized* from the approved disposition of a qualified housing project is the amount realized from such disposition, reduced by—

(*a*) The expenses paid or incurred by the taxpayer which are directly connected with the approved disposition, and

(*b*) The amount of taxes (other than income taxes) paid or incurred by the taxpayer which are attributable to the approved disposition.

(ii) Examples of expenses directly connected with an approved disposition of a qualified housing project include amounts paid for sales or other commissions, advertising, and for the preparation of a deed or other legal services in connection with the disposition. An amount paid for a repair to the building will be considered as an expense directly connected with the approved disposition under subdivision (i)(*a*) of this subparagraph only if such repair is required as a condition of sale, or is required by the Secretary of Housing and Urban Development or his delegate as a condition of approval of the disposition.

(iii) Examples of taxes that are attributable to the approved disposition include local property transfer taxes and stamp taxes. A local real property tax is not so attributable.

(d) *Basis and holding period of replacement project*—(1) *Basis.* If the taxpayer makes an election under section 1039, the basis of the replacement housing project shall be its cost (including costs incurred subsequent to the reinvestment period) reduced by the amount of gain not recognized under section 1039 (a). If the replacement consists of more than one housing project, the basis determined under this subparagraph shall be allocated to the properties in proportion to their respective costs.

(2) *Holding period.* The holding period of the replacement housing project shall begin on the date the taxpayer acquires such project, that is, on the date the taxpayer first acquires possession or control of such project and bears the burdens and enjoys the benefits of ownership of the replacement project. (For special rule regarding the holding period of property for purposes of section 1250, see section 1250(e)(4).)

(e) *Assessment of deficiencies*—(1) *Deficiency attributable to gain.* If a taxpayer makes an election under section 1039(a) with respect to an approved disposition, any deficiency attributable to the gain on such disposition, for any taxable year in which any part of such gain is realized, may be assessed at any time before the expiration of 3 years after the date the district director or director of the regional service center with whom the return for such year has been filed is notified by the taxpayer of the acquisition or the completion of construction or reconstruction of the replacement qualified housing project or of the failure to acquire, construct, or reconstruct a replacement qualified housing project, as the case may be. Such a deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of section 6212(c) or the provisions of any other law or rule of law which would otherwise prevent such assessment. If replacement has been made, such notification shall contain the information required by paragraph (b)(4)(iii) of this section. Such notification shall be attached to the return filed for the taxable year or years in which the replacement occurs, or in which the period for the replacement expires, and a copy of such notification shall be filed with the district director or director of regional service center with whom the election under section 1039(a) was required to be filed, if the return is not filed with such director.

(2) *Deficiency attributable to election.* If gain upon an approved disposition is realized in two (or more) taxable years, and the replacement qualified housing

project was acquired, constructed, or reconstructed before the beginning of the last such year, any deficiency, for any taxable year before such last year, which is attributable to an election by the taxpayer under section 1039(a) may be assessed at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed, notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any law or rule of law which would otherwise prevent such assessment. Thus, if gain upon an approved disposition is realized in 1971 and 1975, and if a replacement project is purchased in 1971, any deficiency for 1971 may be assessed within the period for assessing a deficiency for 1975.

[T.D. 7191, 37 FR 12951, June 30, 1972; 37 FR 14385, July 20, 1972, as amended by T.D. 7400, 41 FR 5101, Feb. 4, 1976]

§ 1.1041–1T Treatment of transfer of property between spouses or incident to divorce (temporary).

Q–1: How is the transfer of property between spouses treated under section 1041?

A–1: Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse or, if the transfer is incident to a divorce, a former spouse. The following questions and answers describe more fully the scope, tax consequences and other rules which apply to transfers of property under section 1041.

(a) *Scope of section 1041 in general.*

Q–2: Does section 1041 apply only to transfers of property incident to divorce?

A–2: No. Section 1041 is not limited to transfers of property incident to divorce. Section 1041 applies to any transfer of property between spouses regardless of whether the transfer is a gift or is a sale or exchange between spouses acting at arm's length (including a transfer in exchange for the relinquishment of property or marital rights or an exchange otherwise governed by another nonrecognition provision of the Code). A divorce or legal separation need not be contemplated between the spouses at the time of the transfer nor must a divorce or legal separation ever occur.

Example 1. A and B are married and file a joint return. A is the sole owner of a condominium unit. A sale or gift of the condominium from A to B is a transfer which is subject to the rules of section 1041.

Example 2. A and B are married and file separate returns. A is the owner of an independent sole proprietorship, X Company. In the ordinary course of business, X Company makes a sale of property to B. This sale is a transfer of property between spouses and is subject to the rules of section 1041.

Example 3. Assume the same facts as in example (2), except that X Company is a corporation wholly owned by A. This sale is not a sale between spouses subject to the rules of section 1041. However, in appropriate circumstances, general tax principles, including the step-transaction doctrine, may be applicable in recharacterizing the transaction.

Q–3: Do the rules of section 1041 apply to a transfer between spouses if the transferee spouse is a nonresident alien?

A–3: No. Gain or loss (if any) is recognized (assuming no other nonrecognition provision applies) at the time of a transfer of property if the property is transferred to a spouse who is a nonresident alien.

Q–4: What kinds of transfers are governed by section 1041?

A–4: Only transfers of property (whether real or personal, tangible or intangible) are governed by section 1041. Transfers of services are not subject to the rules of section 1041.

Q–5: Must the property transferred to a former spouse have been owned by the transferor spouse during the marriage?

A–5: No. A transfer of property acquired after the marriage ceases may be governed by section 1041.

(b) *Transfer incident to the divorce.*

Q–6: When is a transfer of property *incident to the divorce*?

A–6: A transfer of property is *incident to the divorce* in either of the following 2 circumstances—

(1) The transfer occurs not more than one year after the date on which the marriage ceases, or

(2) The transfer is related to the cessation of the marriage.

Thus, a transfer of property occurring not more than one year after the date on which the marriage ceases need not be related to the cessation of the marriage to qualify for section 1041 treatment. (See A–7 for transfers occurring

more than one year after the cessation of the marriage.)

Q–7: When is a transfer of property *related to the cessation of the marriage*?

A–7: A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument, as defined in section 71(b)(2), and the transfer occurs not more than 6 years after the date on which the marriage ceases. A divorce or separation instrument includes a modification or amendment to such decree or instrument. Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one- and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed.

Q–8: Do annulments and the cessations of marriages that are void *ab initio* due to violations of state law constitute divorces for purposes of section 1041?

A–8: Yes.

(c) *Transfers on behalf of a spouse.*

Q–9: May transfers of property to third parties on behalf of a spouse (or former spouse) qualify under section 1041?

A–9: Yes. There are three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under section 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse). The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party. Such consent or ratification must state that the parties intend the transfer to be treated as a transfer to the nontransferring spouse (or former spouse) subject to the rules of section 1041 and must be received by the transferor prior to the date of filing of the transferor's first return of tax for the taxable year in which the transfer was made. In the three situations described above, the transfer of property will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under section 1041. This A–9 shall not apply to transfers to which § 1.1041–2 applies.

(d) *Tax consequences of transfers subject to section 1041.*

Q–10: How is the transferor of property under section 1041 treated for income tax purposes?

A–10: The transferor of property under section 1041 recognizes no gain or loss on the transfer even if the transfer was in exchange for the release of marital rights or other consideration. This rule applies regardless of whether the transfer is of property separately owned by the transferor or is a division (equal or unequal) of community property. Thus, the result under section 1041 differs from the result in *United States* v. *Davis*, 370 U.S. 65 (1962).

Q–11: How is the transferee of property under section 1041 treated for income tax purposes?

A–11: The transferee of property under section 1041 recognizes no gain or loss upon receipt of the transferred property. In all cases, the basis of the transferred property in the hands of the transferee is the adjusted basis of such property in the hands of the transferor immediately before the transfer. Even if the transfer is a bona

fide sale, the transferee does not acquire a basis in the transferred property equal to the transferee's cost (the fair market value). This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of transfer (or the value of any consideration provided by the transferee) and applies for purposes of determining loss as well as gain upon the subsequent disposition of the property by the transferee. Thus, this rule is different from the rule applied in section 1015(a) for determining the basis of property acquired by gift.

Q–12: Do the rules described in A–10 and A–11 apply even if the transferred property is subject to liabilities which exceed the adjusted basis of the property?

A–12: Yes. For example, assume A owns property having a fair market value of $10,000 and an adjusted basis of $1,000. In contemplation of making a transfer of this property incident to a divorce from B, A borrows $5,000 from a bank, using the property as security for the borrowing. A then transfers the property to B and B assumes, or takes the property subject to, the liability to pay the $5,000 debt. Under section 1041, A recognizes no gain or loss upon the transfer of the property, and the adjusted basis of the property in the hands of B is $1,000.

Q–13: Will a transfer under section 1041 result in a recapture of investment tax credits with respect to the property transferred?

A–13: In general, no. Property transferred under section 1041 will not be treated as being disposed of by, or ceasing to be section 38 property with respect to, the transferor. However, the transferee will be subject to investment tax credit recapture if, upon or after the transfer, the property is disposed of by, or ceases to be section 38 property with respect to, the transferee. For example, as part of a divorce property settlement, B receives a car from A that has been used in A's business for two years and for which an investment tax credit was taken by A. No part of A's business is transferred to B and B's use of the car is solely personal. B is subject to recapture of the investment tax credit previously taken by A.

(e) *Notice and recordkeeping requirement with respect to transactions under section 1041.*

Q–14: Does the trasnsferor of property in a transaction described in section 1041 have to supply, at the time of the transfer, the transferee with records sufficient to determine the adjusted basis and holding period of the property at the time of the transfer and (if applicable) with notice that the property transferred under section 1041 is potentially subject to recapture of the investment tax credit?

A–14: Yes. A transferor of property under section 1041 must, at the time of the transfer, supply the transferee with records sufficient to determine the adjusted basis and holding period of the property as of the date of the transfer. In addition, in the case of a transfer of property which carries with it a potential liability for investment tax credit recapture, the transferor must, at the time of the transfer, supply the transferee with records sufficient to determine the amount and period of such potential liability. Such records must be preserved and kept accessible by the transferee.

(f) *Property settlements—effective dates, transitional periods and elections.*

Q–15: When does section 1041 become effective?

A–15: Generally, section 1041 applies to all transfers after July 18, 1984. However, it does not apply to transfers after July 18, 1984 pursuant to instruments in effect on or before July 18, 1984. (See A–16 with respect to exceptions to the general rule.)

Q–16: Are there any exceptions to the general rule stated in A–15 above?

A–16: Yes. Two transitional rules provide exceptions to the general rule stated in A–15. First, section 1041 will apply to transfers after July 18, 1984 under instruments that were in effect on or before July 18, 1984 if both spouses (or former spouses) elect to have section 1041 apply to such transfers. Second, section 1041 will apply to all transfers after December 31, 1983 (including transfers under instruments in effect on or before July 18, 1984) if both spouses (or former spouses) elect

to have section 1041 apply. (See A–18 relating to the time and manner of making the elections under the first or second transitional rule.)

Q–17: Can an election be made to have section 1041 apply to some, but not all, transfers made after December 31, 1983, or some but not all, transfers made after July 18, 1984 under instruments in effect on or before July 18, 1984?

A–17: No. Partial elections are not allowed. An election under either of the two elective transitional rules applies to all transfers governed by that election whether before or after the election is made, and is irrevocable.

(g) *Property settlements—time and manner of making the elections under section 1041.*

Q–18: How do spouses (or former spouses) elect to have section 1041 apply to transfers after December 31, 1983, or to transfers after July 18, 1984 under instruments in effect on or before July 18, 1984?

A–18: In order to make an election under section 1041 for property transfers after December 31, 1983, or property transfers under instruments that were in effect on or before July 18, 1984, both spouses (or former spouses) must elect the application of the rules of section 1041 by attaching to the transferor's first filed income tax return for the taxable year in which the first transfer occurs, a statement signed by both spouses (or former spouses) which includes each spouse's social security number and is in substantially the form set forth at the end of this answer.

In addition, the transferor must attach a copy of such statement to his or her return for each subsequent taxable year in which a transfer is made that is governed by the transitional election. A copy of the signed statment must be kept by both parties.

The election statements shall be in substantially the following form:

In the case of an election regarding transfers after 1983:

SECTION 1041 ELECTION

The undersigned hereby elect to have the provisions of section 1041 of the Internal Revenue Code apply to all qualifying transfers of property after December 31, 1983. The undersigned understand that section 1041 applies to all property transferred between spouses, or former spouses incident to divorce. The parties further understand that the effects for Federal income tax purposes of having section 1041 apply are that (1) no gain or loss is recognized by the transferor spouse or former spouse as a result of this transfer; and (2) the basis of the transferred property in the hands of the transferee is the adjusted basis of the property in the hands of the transferor immediately before the transfer, whether or not the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of the transfer. The undersigned understand that if the transferee spouse or former spouse disposes of the property in a transaction in which gain is recognized, the amount of gain which is taxable may be larger than it would have been if this election had not been made.

In the case of an election regarding preexisting decrees:

SECTION 1041 ELECTION

The undersigned hereby elect to have the provisions of section 1041 of the Internal Revenue Code apply to all qualifying transfers of property after July 18, 1984 under any instrument in effect on or before July 18, 1984. The undersigned understand that section 1041 applies to all property transferred between spouses, or former spouses incident to the divorce. The parties further understand that the effects for Federal income tax purposes of having section 1041 apply are that (1) no gain or loss is recognized by the transferor spouse or former spouse as a result of this transfer; and (2) the basis of the transferred property in the hands of the transferee is the adjusted basis of the property in the hands of the transferor immediately before the transfer, whether or not the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of the transfer. The undersigned understand that if the transferee spouse or former spouse disposes of the property in a transaction in which gain is recognized, the amount of gain which is taxable may be larger than it would have been if this election had not been made.

(Secs. 1041(d)(4), (98 Stat. 798, 26 U.S.C. 1041(d)(4)), 152(e)(2)(A) (98 Stat. 802, 26 U.S.C. 152(e)(2)(A)), 215(c) (98 Stat. 800, 26 U.S.C. 215(c)) and 7805 (68A Stat. 917, 26 U.S.C. 7805) of the Internal Revenue Code of 1954))

[T.D. 7973, 49 FR 34452, Aug. 31, 1984; T.D. 9035, 68 FR 1536, Jan. 13, 2003]

§ 1.1041–2 Redemptions of stock.

(a) *In general*—(1) *Redemptions of stock not resulting in constructive distributions.* Notwithstanding Q&A–9 of § 1.1041–

1T(c), if a corporation redeems stock owned by a spouse or former spouse (transferor spouse), and the transferor spouse's receipt of property in respect of such redeemed stock is not treated, under applicable tax law, as resulting in a constructive distribution to the other spouse or former spouse (nontransferor spouse), then the form of the stock redemption shall be respected for Federal income tax purposes. Therefore, the transferor spouse will be treated as having received a distribution from the corporation in redemption of stock.

(2) *Redemptions of stock resulting in constructive distributions.* Notwithstanding Q&A–9 of §1.1041–1T(c), if a corporation redeems stock owned by a transferor spouse, and the transferor spouse's receipt of property in respect of such redeemed stock is treated, under applicable tax law, as resulting in a constructive distribution to the nontransferor spouse, then the redeemed stock shall be deemed first to be transferred by the transferor spouse to the nontransferor spouse and then to be transferred by the nontransferor spouse to the redeeming corporation. Any property actually received by the transferor spouse from the redeeming corporation in respect of the redeemed stock shall be deemed first to be transferred by the corporation to the nontransferor spouse in redemption of such spouse's stock and then to be transferred by the nontransferor spouse to the transferor spouse.

(b) *Tax consequences*—(1) *Transfers described in paragraph (a)(1) of this section.* Section 1041 will not apply to any of the transfers described in paragraph (a)(1) of this section. See section 302 for rules relating to the tax consequences of certain redemptions; redemptions characterized as distributions under section 302(d) will be subject to section 301 if received from a Subchapter C corporation or section 1368 if received from a Subchapter S corporation.

(2) *Transfers described in paragraph (a)(2) of this section.* The tax consequences of each deemed transfer described in paragraph (a)(2) of this section are determined under applicable provisions of the Internal Revenue Code as if the spouses had actually made such transfers. Accordingly, section 1041 applies to any deemed transfer of the stock and redemption proceeds between the transferor spouse and the nontransferor spouse, provided the requirements of section 1041 are otherwise satisfied with respect to such deemed transfer. Section 1041, however, will not apply to any deemed transfer of stock by the nontransferor spouse to the redeeming corporation in exchange for the redemption proceeds. *See* section 302 for rules relating to the tax consequences of certain redemptions; redemptions characterized as distributions under section 302(d) will be subject to section 301 if received from a Subchapter C corporation or section 1368 if received from a Subchapter S corporation.

(c) *Special rules in case of agreements between spouses or former spouses*—(1) *Transferor spouse taxable.* Notwithstanding applicable tax law, a transferor spouse's receipt of property in respect of the redeemed stock shall be treated as a distribution to the transferor spouse in redemption of such stock for purposes of paragraph (a)(1) of this section, and shall not be treated as resulting in a constructive distribution to the nontransferor spouse for purposes of paragraph (a)(2) of this section, if a divorce or separation instrument, or a valid written agreement between the transferor spouse and the nontransferor spouse, expressly provides that—

(i) Both spouses or former spouses intend for the redemption to be treated, for Federal income tax purposes, as a redemption distribution to the transferor spouse; and

(ii) Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.

(2) *Nontransferor spouse taxable.* Notwithstanding applicable tax law, a transferor spouse's receipt of property in respect of the redeemed stock shall be treated as resulting in a constructive distribution to the nontransferor spouse for purposes of paragraph (a)(2) of this section, and shall not be treated as a distribution to the transferor spouse in redemption of such stock for

purposes of paragraph (a)(1) of this section, if a divorce or separation instrument, or a valid written agreement between the transferor spouse and the nontransferor spouse, expressly provides that—

(i) Both spouses or former spouses intend for the redemption to be treated, for Federal income tax purposes, as resulting in a constructive distribution to the nontransferor spouse; and

(ii) Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.

(3) *Execution of agreements.* For purposes of this paragraph (c), a divorce or separation instrument must be effective, or a valid written agreement must be executed by both spouses or former spouses, prior to the date on which the transferor spouse (in the case of paragraph (c)(1) of this section) or the nontransferor spouse (in the case of paragraph (c)(2) of this section) files such spouse's first timely filed Federal income tax return for the year that includes the date of the stock redemption, but no later than the date such return is due (including extensions).

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

Example 1. Corporation X has 100 shares outstanding. A and B each own 50 shares. A and B divorce. The divorce instrument requires B to purchase A's shares, and A to sell A's shares to B, in exchange for $100x. Corporation X redeems A's shares for $100x. Assume that, under applicable tax law, B has a primary and unconditional obligation to purchase A's stock, and therefore the stock redemption results in a constructive distribution to B. Also assume that the special rule of paragraph (c)(1) of this section does not apply. Accordingly, under paragraphs (a)(2) and (b)(2) of this section, A shall be treated as transferring A's stock of Corporation X to B in a transfer to which section 1041 applies (assuming the requirements of section 1041 are otherwise satisfied), B shall be treated as transferring the Corporation X stock B is deemed to have received from A to Corporation X in exchange for $100x in an exchange to which section 1041 does not apply and sections 302(d) and 301 apply, and B shall be treated as transferring the $100x to A in a transfer to which section 1041 applies.

Example 2. Assume the same facts as *Example 1,* except that the divorce instrument provides as follows: ''A and B agree that the redemption will be treated for Federal income tax purposes as a redemption distribution to A.'' The divorce instrument further provides that it ''supersedes all other instruments or agreements concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.'' By virtue of the special rule of paragraph (c)(1) of this section and under paragraphs (a)(1) and (b)(1) of this section, the tax consequences of the redemption shall be determined in accordance with its form as a redemption of A's shares by Corporation X and shall not be treated as resulting in a constructive distribution to B. See section 302.

Example 3. Assume the same facts as *Example 1,* except that the divorce instrument requires A to sell A's shares to Corporation X in exchange for a note. B guarantees Corporation X's payment of the note. Assume that, under applicable tax law, B does not have a primary and unconditional obligation to purchase A's stock, and therefore the stock redemption does not result in a constructive distribution to B. Also assume that the special rule of paragraph (c)(2) of this section does not apply. Accordingly, under paragraphs (a)(1) and (b)(1) of this section, the tax consequences of the redemption shall be determined in accordance with its form as a redemption of A's shares by Corporation X. See section 302.

Example 4. Assume the same facts as *Example 3,* except that the divorce instrument provides as follows: ''A and B agree the redemption shall be treated, for Federal income tax purposes, as resulting in a constructive distribution to B.'' The divorce instrument further provides that it ''supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.'' By virtue of the special rule of paragraph (c)(2) of this section, the redemption is treated as resulting in a constructive distribution to B for purposes of paragraph (a)(2) of this section. Accordingly, under paragraphs (a)(2) and (b)(2) of this section, A shall be treated as transferring A's stock of Corporation X to B in a transfer to which section 1041 applies (assuming the requirements of section 1041 are otherwise satisfied), B shall be treated as transferring the Corporation X stock B is deemed to have received from A to Corporation X in exchange for a note in an exchange to which section 1041 does not apply and sections 302(d) and 301 apply, and B shall be treated as transferring the note to A in a transfer to which section 1041 applies.

(e) *Effective date.* Except as otherwise provided in this paragraph, this section is applicable to redemptions of stock on or after January 13, 2003, except for redemptions of stock that are pursuant

to instruments in effect before January 13, 2003. For redemptions of stock before January 13, 2003 and redemptions of stock that are pursuant to instruments in effect before January 13, 2003, see § 1.1041–1T(c), A–9. However, these regulations will be applicable to redemptions described in the preceding sentence of this paragraph (e) if the spouses or former spouses execute a written agreement on or after August 3, 2001 that satisfies the requirements of one of the special rules in paragraph (c) of this section with respect to such redemption. A divorce or separation instrument or valid written agreement executed on or after August 3, 2001, and before May 13, 2003 that meets the requirements of the special rule in Regulations Project REG–107151–00 published in 2001–2 C.B. 370 (*see* § 601.601(d)(2) of this chapter) will be treated as also meeting the requirements of the special rule in paragraph (c)(2) of this section.

[T.D. 9035, 68 FR 1536, Jan. 13, 2003]

§ 1.1042–1T Questions and answers relating to the sales of stock to employee stock ownership plans or certain cooperatives (temporary).

Q–1: What does section 1042 provide?

A–1: (a) Section 1042 provides rules under which a taxpayer may elect not to recognize gain in certain cases where *qualified securities* are sold to a qualifying employee stock ownership plan or worker-owned cooperative in taxable years of the seller beginning after July 18, 1984, and *qualified replacement property* is purchased by the taxpayer within the *replacement period*. If the requirements of Q&A–2 of this section are met, and if the taxpayer makes an election under section 1042(a) in accordance with Q&A–3 of this section, the gain realized by the taxpayer on the sale of the qualified securities is recognized only to the extent that the amount realized on such sale exceeds the cost to the taxpayer of the qualified replacement property.

(b) Under section 1042, the term *qualified securities* means employer securities (as defined in section 409(l)) with respect to which each of the following requirements is satisfied: (1) The employer securities were issued by a domestic corporation; (2) for at least one year before and immediately after the sale, the domestic corporation that issued the employer securities (and each corporation that is a member of a *controlled group of corporations* with such corporation for purposes of section 409(l)) has no stock outstanding that is readily tradeable on an established market; (3) as of the time of the sale, the employer securities have been held by the taxpayer for more than 1 year; and (4) the employer securities were not received by the taxpayer in a distribution from a plan described in section 401(a) or in a transfer pursuant to an option or other right to acquire stock to which section 83, 422, 422A, 423, or 424 applies.

(c) The term *replacement period* means the period which begins 3 months before the date on which the sale of qualified securities occurs and which ends 12 months after the date of such sale. A replacement period may include any period which occurs prior to July 19, 1984.

(d) The term *qualified replacement property* means any securities (as defined in section 165(g)(2)) issued by a domestic corporation which does not, for the taxable year of such corporation in which the securities are purchased by the taxpayer, have passive investment income (as defined in section 1362(d)(3)(D)) that exceeds 25 percent of the gross receipts of such corporation for the taxable year preceding the taxable year of purchase. In addition, securities of the domestic corporation that issued the employer securities qualifying under section 1042 (and of any corporation that is a member of a *controlled group of corporations* with such corporation for purposes of section 409(l)) will not qualify as *qualified replacement property*.

(e) For purposes of section 1042(a), there is a *purchase* of qualified replacement property only if the basis of such property is determined by reference to its cost to the taxpayer. If the basis of the qualified replacement property is determined by reference to its basis in the hands of the transferor thereof or another person, or by reference to the basis of property (other than cash or its equivalent) exchanged for such

property, then the basis of such property is not determined solely by reference to its cost to the taxpayer.

Q–2: What is a sale of qualified securities for purposes of section 1042(b)?

A–2: (a) Under section 1042(b), a sale of qualified securities is one under which all of the following requirements are met:

(1) The qualified securities are sold to an employee stock ownership plan (as defined in section 4975(e)(7)) maintained by the corporation that issued the qualified securities (or by a member of the *controlled group of corporations* with such corporation for purposes of section 409(l)) or to an eligible worker-owned cooperative (as defined in section 1042(c)(2));

(2) The employee stock ownership plan or eligible worker-owned cooperative owns, immediately after the sale, 30 percent or more of the total value of the employer securities (within the meaning of section 409(l) outstanding as of such time;

(3) No portion of the assets of the employee stock ownership plan or eligible worker-owned cooperative attributable to qualified securities that are sold to the plan or cooperative by the taxpayer or by any other person in a sale with respect to which an election under section 1042(a) is made accrue under the plan or are allocated by the cooperative, either directly or indirectly and either concurrently with or at any time thereafter, for the benefit of (i) the taxpayer; (ii) any person who is a member of the family of the taxpayer (within the meaning of section 267(c)(4)); or (iii) any person who owns (after the application of section 318(a)), at any time after July 18, 1984, and until immediately after the sale, more than 25 percent of in value of the outstanding portion of any class of stock of the corporation that issued the qualified securities (or of any member of the *controlled group of corporations* with such corporation for purposes of section 409(l)). For purposes of this calculation, stock that is owned, directly or indirectly, by or for a qualified plan shall not be treated as outstanding.

(4) The taxpayer files with the Secretary (as part of the required election described in Q&A–3 of this section) a verified written statement of the domestic corporation (or corporations) whose employees are covered by the plan acquiring the qualified securities or of any authorized officer of the eligible workerowned cooperative, consenting to the application of section 4978(a) with respect to such corporation or cooperative.

(b) For purposes of determining whether paragraph (a)(2) of this section is satisfied, sales of qualified securities by two or more taxpayers may be treated as a single sale if such sales are made as part of a single, integrated transaction under a prearranged agreement between the taxpayers.

(c) For purposes of determining whether paragraph (a)(3) of this section is satisfied with respect to the prohibition against an accrual or allocation of qualified securities, the accrual or allocation of any benefits or contributions or other assets that are not attributable to qualified securities sold to the employee stock ownership plan or eligible worker-owned cooperative in a sale with respect to which an election under section 1042(a) is made (including any accrual or allocation under any other plan or arrangement maintained by the corporation or any member of *the controlled group of corporations* with such corporation for purposes of section 409(l)) must be made without regard to the allocation of such qualified securities. Paragraph (a)(3) of this section above may be illustrated in part by the following example: Individuals A, B, and C own 50, 25, and 25, respectively, of the 100 outstanding shares of common stock of Corporation X. Such shares constitute qualified securities as defined in Q&A–1 of this section. A and B, but not C, are employees of Corporation X. For the benefit of all its employees, Corporation X establishes an employee stock ownership plan that obtains a loan meeting the exemption requirements of section 4975(d)(3). The loan proceeds are used by the plan to purchase the 100 shares of qualified securities from A, B, and C, all of whom elect nonrecognition treatment under section 1042(a) with respect to the gain realized on their sale of such securities. Under the requirements of paragraph (a)(3) of this section, no part of the assets of the plan attributable to the 100

shares of qualified securities may accrue under the plan (or under any other plan or arrangement maintained by Corporation X) for the benefit of A or B or any person who is a member of the family of A or B (as determined under section 267(c)(4)). Furthermore, no other assets of the plan or assets of the employer may accrue for the benefit of such individuals in lieu of the receipt of assets attributable to such qualified securities.

(d) A sale under section 1042(a) shall not include any sale of securities by a dealer or underwriter in the ordinary course of its trade or business as a dealer or underwriter, whether or not guaranteed.

Q–3: What is the time and manner for making the election under section 1042(a)?

A–3: (a) The election not to recognize the gain realized upon the sale of qualified securities to the extent provided under section 1042(a) shall be made in a *statement of election* attached to the taxpayer's income tax return filed on or before the due date (including extensions of time) for the taxable year in which the sale occurs. If a taxpayer does not make a timely election under this section to obtain section 1042(a) nonrecognition treatment with respect to the sale of qualified securities, it may not subsequently make an election on an amended return or otherwise. Also, an election once made is irrevocable.

(b) The statement of election shall provide that the taxpayer elects to treat the sale of securities as a sale of qualified securities under section 1042(a), and shall contain the following information:

(1) A description of the qualified securities sold, including the type and number of shares;

(2) The date of the sale of the qualified securities;

(3) The adjusted basis of the qualified securities;

(4) The amount realized upon the sale of the qualified securities;

(5) The identity of the employee stock ownership plan or eligible worker-owned cooperative to which the qualified securities were sold; and

(6) If the sale was part of a single, interrelated transaction under a prearranged agreement between taxpayers involving other sales of qualified securities, the names and taxpayer identification numbers of the other taxpayers under the agreement and the number of shares sold by the other taxpayers. See Q&A–2 of this section.

If the taxpayer has purchased qualified replacement property at the time of the election, the taxpayer must attach as part of the statement of election a *statement of purchase* describing the qualified replacement property, the date of the purchase, and the cost of the property, and declaring such property to be the qualified replacement property with respect to the sale of qualified securities. Such statement of purchase must be notarized by the later of thirty days after the purchase or March 6, 1986. In addition, the statement of election must be accompanied by the verified written statement of consent required under Q&A–2 of this section with respect to the qualified securities sold.

(c) If the taxpayer has not purchased qualified replacement property at the time of the filing of the statement of election, a timely election under this Q&A shall not be considered to have been made unless the taxpayer attaches the notarized statement of purchase described above to the taxpayer's income tax return filed for the taxable year following the year for which the election under section 1042(a) was made. Such notarized statement of purchase shall be filed with the district director or the director of the regional service center with whom such election was originally filed, if the return is not filed with such director.

Q–4: What is the basis of qualified replacement property?

A–4: If a taxpayer makes an election under section 1042(a), the basis of the qualified replacement property purchased by the taxpayer during the replacement period shall be reduced by an amount equal to the amount of gain which was not recognized. If more than one item of qualified replacement property is purchased, the basis of each of such items shall be reduced by an amount determined by multiplying the total gain not recognized by reason of the application of section 1042(a) by a fraction, the numerator of which is the

cost of such item of property and the denominator of which is the total cost of all such items of property. For the rule regarding the holding period of qualified replacement property, see section 1223(13).

Q–5: What is the statute of limitations for the assessment of a deficiency relating to the gain on the sale of qualified securities?

A–5: (a) If any gain is realized by the taxpayer on the sale of any qualified securities and such gain has not been recognized under section 1042(a) in accordance with the requirements of this section, the statutory period provided in section 6501(a) for the assessment of any deficiency with respect to such gain shall not expire prior to the expiration of 3 years from the date of receipt, by the district director or director of regional service center with whom the statement of election under 1042(a) was originally filed, of:

(1) A notarized statement of purchase as described in Q&A–3;

(2) A written statement of the taxpayer's intention not to purchase qualified replacement property within the replacement period; or

(3) A written statement of the taxpayer's failure to purchase qualified replacement property within the replacement period.

In those situations when a taxpayer is providing a written statement of an intention not to purchase or of a failure to purchase qualified replacement property, the statement shall be accompanied, where appropriate, by an amended return for the taxable year in which the gain from the sale of the qualified securities was realized, in order to reflect the inclusion in gross income for that year of gain required to be recognized in connection with such sale.

(b) Any gain from the sale of qualified securities which is required to be recognized due to a failure to meet the requirements under section 1042 shall be included in the gross income for the taxable year in which the gain was realized. If any gain from the sale of qualified securities is not recognized under section 1042(a) in accordance with the requirements of this section, any deficiency attributable to any portion of such gain may be assessed at any time before the expiration of the 3-year period described in this Q&A, notwithstanding the provision of any law or rule of law which would otherwise prevent such assessment.

Q–6: When does section 1042 become effective?

A–6: Section 1042 applies to sales of qualified securities in taxable years of sellers beginning after July 18, 1984.

[T.D. 8073, 51 FR 4333, Feb. 4, 1986]

§ 1.1044(a)–1 Time and manner for making election under the Omnibus Budget Reconciliation Act of 1993.

(a) *Description*. Section 1044(a), as added by section 13114 of the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103–66, 107 Stat. 430), generally allows individuals and C corporations that sell publicly traded securities after August 9, 1993, to elect not to recognize certain gain from the sale if the taxpayer purchases common stock or a partnership interest in a specialized small business investment company (SSBIC) within the 60-day period beginning on the date the publicly traded securities are sold.

(b) *Time and manner for making the election*. The election under section 1044(a) must be made on or before the due date (including extensions) for the income tax return for the year in which the publicly traded securities are sold. The election is to be made by reporting the entire gain from the sale of publicly traded securities on Schedule D of the income tax return in accordance with instructions for Schedule D, and by attaching a statement to Schedule D showing—

(1) How the nonrecognized gain was calculated;

(2) The SSBIC in which common stock or a partnership interest was purchased;

(3) The date the SSBIC stock or partnership interest was purchased; and

(4) The basis of the SSBIC stock or partnership interest.

(c) *Revocability of election*. The election described in this section is revocable with the consent of the Commissioner.

(d) *Effective date*. The rules set forth in this section are effective December 12, 1996.

[T.D. 8688, 61 FR 65322, Dec. 12, 1996]

§ 1.1045–1 Application to partnerships.

(a) *Overview of section.* A partnership that holds qualified small business stock (QSB stock) (as defined in paragraph (g)(1) of this section) for more than 6 months, sells such QSB stock, and purchases replacement QSB stock (as defined in paragraph (g)(2) of this section) may elect to apply section 1045. An eligible partner (as defined in paragraph (g)(3) of this section) of a partnership that sells QSB stock, may elect to apply section 1045 if the eligible partner purchases replacement QSB stock directly or through a purchasing partnership (as defined in paragraph (c)(1)(i) of this section). A taxpayer (other than a C corporation) that holds QSB stock for more than 6 months, sells such QSB stock and purchases replacement QSB stock through a purchasing partnership may elect to apply section 1045. A section 1045 election is revocable only with the prior written consent of the Commissioner. To obtain the Commissioner's prior written consent, the person who made the section 1045 election must submit a request for a private letter ruling. (For further guidance, see Rev. Proc. 2007–1, 2007–1 CB 1 (or any applicable successor) and § 601.601(d)(2)(ii)(*b*) of this chapter.) Paragraph (b) of this section provides rules for partnerships that elect to apply section 1045. Paragraph (c) of this section provides rules for certain taxpayers other than C corporations and for eligible partners that elect to apply section 1045. Paragraph (d) of this section provides a limitation on the amount of gain that an eligible partner does not recognize under section 1045. Paragraph (e) of this section provides rules for partnership distributions of QSB stock to an eligible partner. Paragraph (f) of this section provides rules for contributions of QSB stock or replacement QSB stock to a partnership. Paragraph (g) of this section provides definitions of certain terms used in section 1045 and this section. Paragraph (h) of this section provides reporting rules for partnerships and partners that elect to apply section 1045. Paragraph (i) of this section provides examples illustrating the provisions of this section. Paragraph (j) of this section contains the effective/applicability date.

(b) *Partnership election*—(1) *Partnership purchase of replacement QSB stock.* A partnership that holds QSB stock for more than 6 months, sells such QSB stock, and purchases replacement QSB stock may elect in accordance with paragraph (h) of this section to apply section 1045. If the partnership elects to apply section 1045, then, subject to the provisions of paragraphs (b)(4) and (d) of this section, each eligible partner shall not recognize its distributive share of any partnership section 1045 gain (as determined under paragraph (b)(2) of this section). For this purpose, partnership section 1045 gain equals the partnership's gain from the sale of the QSB stock reduced by the greater of—

(i) The amount of the gain from the sale of the QSB stock that is treated as ordinary income; or

(ii) The excess of the amount realized by the partnership on the sale over the total cost of all replacement QSB stock purchased by the partnership (excluding the cost of any replacement QSB stock purchased by the partnership that is otherwise taken into account under section 1045).

(2) *Partner's distributive share of partnership section 1045 gain.* A partner's distributive share of partnership section 1045 gain shall be in the same proportion as the partner's distributive share of the partnership's gain from the sale of the QSB stock. For this purpose, the partnership's gain from the sale of QSB stock and the partner's distributive share of that gain are determined without regard to basis adjustments under section 743(b) and paragraph (b)(3)(ii) of this section.

(3) *Basis adjustments*—(i) *Partner's interest in a partnership.* The adjusted basis of an eligible partner's interest in a partnership shall not be increased under section 705(a)(1) by gain from a partnership's sale of QSB stock that is not recognized by the partner as the result of a partnership election under paragraph (b)(1) of this section.

(ii) *Partnership's replacement QSB stock*—(A) *Rule.* The basis of a partnership's replacement QSB stock is reduced (in the order acquired) by the amount of gain from the partnership's sale of QSB stock that is not recognized by an eligible partner as a result

of the partnership's election under section 1045. The basis adjustment with respect to any amount described in this paragraph (b)(3)(ii) constitutes an adjustment to the basis of the partnership's replacement QSB stock with respect to that partner only. The effect of such a basis adjustment is determined under the principles of §1.743–1(g), (h), and (j) except as modified in this paragraph (b)(3)(ii)(A). If a partnership sells QSB stock with respect to which a basis adjustment has been made under this paragraph (b)(3)(ii), and the partnership makes an election under paragraph (b)(1) of this section with respect to the sale and purchases replacement QSB stock, the basis adjustment shall carry over to the replacement QSB stock except to the extent otherwise provided in this paragraph (b)(3)(ii). The basis adjustment that carries over to the replacement QSB stock shall be reduced (but not below zero) by the eligible partner's distributive share of the excess, if any, of the greater of the amount determined under paragraph (b)(1)(i) or (ii) of this section from the sale of the QSB stock, over the partnership's gain from the sale of the QSB stock (determined without regard to basis adjustments under section 743 or paragraph (b)(3)(ii) of this section). The excess amount that reduces the basis adjustment shall be accounted for as gain in accordance with §1.743–1(j)(3). See *Example 5* of paragraph (i) of this section. For purposes of this paragraph (b)(3)(ii), a partnership must presume that a partner did not recognize that partner's distributive share of the partnership section 1045 gain as a result of the partnership's section 1045 election unless the partner notifies the partnership to the contrary as described in paragraph (b)(5)(ii) of this section. However, if a partnership knows that a particular partner is classified, for Federal tax purposes, as a C corporation, then the partnership may presume that the partner did not defer recognition of its distributive share of the partnership section 1045 gain, even in the absence of a notification by the partner. If a partnership makes an election under section 1045, but an eligible partner opts out of the election under paragraph (b)(4) of this section and provides to the partnership the notification required under paragraph (b)(5)(ii) of this section, no basis adjustments under this paragraph (b)(3)(ii) are required with respect to that partner as a result of the section 1045 election by the partnership.

(B) *Tiered-partnership rule*. If a partnership (upper-tier partnership) holds an interest in another partnership (lower-tier partnership) that makes an election under section 1045, the portion of the lower-tier partnership's basis adjustment as provided in paragraph (b)(3)(ii)(A) of this section in the replacement QSB stock must be segregated and allocated to the upper-tier partnership and any eligible partner as defined in paragraph (g)(3)(iii) of this section. Similarly, that portion of the basis of the upper-tier partnership's interest in the lower-tier partnership attributable to the basis adjustment as provided in paragraph (b)(3)(ii)(A) of this section in the lower-tier partnership's replacement QSB stock must be segregated and allocated solely to any eligible partner as defined in paragraph (g)(2)(iii) of this section.

(C) *Statement of adjustments*. A partnership that must adjust the basis of replacement QSB stock under this paragraph (b) must attach a statement to the partnership return for the taxable year in which the partnership purchases replacement QSB stock setting forth the computation of the adjustment, the replacement QSB stock to which the adjustment has been made, the date(s) on which such QSB stock was acquired by the partnership, and the amount of the adjustment that is allocated to each partner.

(4) *Eligible partners may opt out of partnership's section 1045 election*. An eligible partner may opt out of the partnership's section 1045 election with respect to QSB stock either by recognizing the partner's distributive share of the partnership section 1045 gain, or by making a partner section 1045 election under paragraph (c) of this section with respect to the partner's distributive share of the partnership section 1045 gain. See paragraph (b)(5)(ii) of this section for applicable notification requirements. Opting out of a partnership's section 1045 election under this paragraph (b)(4) does not constitute a

revocation of the partnership's election, and such election shall continue to apply to other partners of the partnership.

(5) *Notice requirements*—(i) *Partnership notification to partners.* A partnership that makes an election under paragraph (b)(1) of this section must notify all of its partners of the election and the purchase of replacement QSB stock, in accordance with the applicable forms and instructions, and separately state each partner's distributive share of partnership section 1045 gain from the sale of QSB stock under section 702. Each partner shall determine whether the partner is an eligible partner within the meaning of paragraph (g)(3) of this section and report the partner's distributive share of partnership section 1045 gain from the partnership's sale of QSB stock, including gain not recognized, in accordance with the applicable forms and instructions.

(ii) *Partner notification to partnership.* Any partner that must recognize all or part of the partner's distributive share of partnership section 1045 gain must notify the partnership, in writing, of the amount of partnership section 1045 gain that is recognized by the partner. Similarly, an eligible partner that opts out of a partnership's section 1045 election under paragraph (b)(4) of this section must notify the partnership, in writing, that the partner is opting out of the partnership's section 1045 election.

(c) *Partner election*—(1) *In general*—(i) *Rule.* An eligible partner of a partnership that sells QSB stock (selling partnership) may elect in accordance with paragraph (h) of this section to apply section 1045 if replacement QSB stock is purchased by the eligible partner. An eligible partner of a selling partnership may elect in accordance with paragraph (h) of this section to apply section 1045 if replacement QSB stock is purchased by a partnership in which the taxpayer is a partner (directly or through an upper-tier partnership) on the date on which the partnership acquires the replacement QSB stock (purchasing partnership). A taxpayer other than a C corporation that sells QSB stock held for more than 6 months at the time of the sale may elect in accordance with paragraph (h) of this section to apply section 1045 if replacement QSB stock is purchased by a purchasing partnership (including a selling partnership).

(ii) *Partner purchase of replacement QSB stock.* Subject to paragraph (d) of this section, an eligible partner of a selling partnership that elects to apply section 1045 with respect to the eligible partner's purchase of replacement QSB stock must recognize its distributive share of gain from the sale of QSB stock by the selling partnership only to the extent of the greater of—

(A) The amount of the eligible partner's distributive share of the selling partnership's gain from the sale of the QSB stock that is treated as ordinary income; or

(B) The excess of the eligible partner's share of the selling partnership's amount realized (as determined under paragraph (c)(2) of this section) on the sale by the selling partnership of the QSB stock (excluding the cost of any replacement QSB stock purchased by the selling partnership) over the cost of any replacement QSB stock purchased by the eligible partner (excluding the cost of any replacement QSB stock that is otherwise taken into account under section 1045).

(iii) *Partnership purchase of replacement QSB stock—(A) Partner of a selling partnership.* Subject to paragraph (d) of this section, an eligible partner that treats its interest in QSB stock purchased by a purchasing partnership as a purchase of replacement QSB stock by the eligible partner and that elects to apply section 1045 with respect to such purchase must recognize its total gain (the eligible partner's distributive share of gain from the selling partnership's sale of QSB stock and any gain taken into account under paragraph (c)(5) of this section from the sale of replacement QSB stock) only to the extent of the greater of—

(*1*) The amount of the eligible partner's distributive share of the selling partnership's gain from the sale of the QSB stock that is treated as ordinary income; or

(*2*) The excess of the eligible partner's share of the selling partnership's amount realized (as determined under paragraph (c)(2) of this section) on the sale by the selling partnership of the

QSB stock (excluding the cost of any replacement QSB stock purchased by the selling partnership) over the eligible partner's share of the purchasing partnership's cost of the replacement QSB stock, as determined under paragraph (c)(3) of this section (excluding the cost of any QSB stock that is otherwise taken into account under section 1045).

(B) *Taxpayer other than a C corporation.* Subject to paragraph (d) of this section, a taxpayer other than a C corporation that treats its interest in QSB stock purchased by a purchasing partnership with respect to which the taxpayer is a partner as a purchase of replacement QSB stock by the taxpayer must recognize its gain from the sale of the QSB stock only to the extent of the greater of—

(*1*) The amount of gain from the sale of the QSB stock that is treated as ordinary income; or

(*2*) The excess of the amount realized by the taxpayer on the sale of the QSB stock over the partner's share of the purchasing partnership's cost of the replacement QSB stock, as determined under paragraph (c)(3) of this section (excluding the cost of any QSB stock that is otherwise taken into account under section 1045).

(2) *Eligible partner's share of amount realized by partnership*—(i) *General rule.* The eligible partner's share of the amount realized by the selling partnership is the amount realized by the partnership on the sale of the QSB stock (excluding the cost of any replacement QSB stock otherwise taken into account under section 1045) multiplied by the following fraction—

(A) The numerator of which is the eligible partner's distributive share of the partnership's realized gain from the sale of the QSB stock; and

(B) The denominator of which is the partnership's realized gain on the sale of the QSB stock.

(ii) *General rule modified for determining eligible partner's share of amount realized by purchasing partnership upon a sale of replacement QSB stock in certain situations*—(A) *No gain realized or loss realized on sale of replacement QSB stock.* If a purchasing partnership does not realize a gain or realizes a loss from the sale of replacement QSB stock for which an election under this section was made for purposes of applying paragraph (c)(1)(iii)(A) of this section, the eligible partner's share of the amount realized is—

(*1*) The greater of—

(*i*) The amount determined in paragraph (c)(2)(i) of this section from a prior sale of QSB stock (that is not otherwise taken into account under paragraph (c)(2) of this section) in which the eligible partner had a distributive share of gain allocated to the eligible partner that was not recognized under paragraph (c)(1)(iii)(A) of this section; or

(*ii*) The amount realized by a taxpayer other than a C corporation from a prior sale of QSB stock (that is not otherwise taken into account under paragraph (c)(2) of this section) in which the taxpayer realized gain that was not recognized under paragraph (c)(1)(iii)(B) of this section; less

(*2*) The eligible partner's distributive share of any loss recognized on the sale of replacement QSB stock, if applicable.

(B) *Eligible partner's interest in purchasing partnership is reduced and gain realized on sale of replacement QSB stock.* If an eligible partner's interest in a purchasing partnership is reduced subsequent to the sale of QSB stock and the purchasing partnership realizes a gain from the sale of the replacement QSB stock, the eligible partner's share of the amount realized upon a sale of replacement QSB stock must be determined under paragraph (c)(2)(i) of this section based on the distributive share of the partnership's realized gain that would have been allocated to the eligible partner if the eligible partner's interest in the partnership had not been reduced.

(iii) *Eligible partner's share of the amount realized.* For purposes of determining the eligible partner's share of the amount realized by the partnership, the partnership's realized gain from the sale of QSB stock and the eligible partner's distributive share of that gain are determined without regard to basis adjustments under section 743(b) and paragraphs (b)(3)(ii) and (c) of this section.

(3) *Partner's share of the cost of QSB stock purchased by a purchasing partnership*. The partner's share of the cost (adjusted basis) of replacement QSB stock purchased by a purchasing partnership is the percentage of the partnership's future income and gain, if any, that is reasonably expected to be allocated to the partner (determined without regard to any adjustment under section 1045) with respect to the replacement QSB stock that was purchased by the partnership, multiplied by the cost of that replacement QSB stock. The assumptions made by a partnership in determining the reasonably expected allocation of income and gain must be consistent for each partner. For example, a partnership may not treat the same item of income or gain as being reasonably expected to be allocated to more than one partner.

(4) *Basis adjustments*—(i) *Eligible partner's interest in selling partnership*. Under section 705(a)(1), the adjusted basis of an eligible partner's interest in a selling partnership that sells QSB stock is increased by the partner's distributive share of gain without regard to paragraph (c)(1) of this section. However, if the selling partnership is also a purchasing partnership, the adjusted basis of an eligible partner's interest in a partnership that sells QSB stock may be reduced under paragraph (c)(4)(iii) of this section.

(ii) *Replacement QSB stock*. A partner's basis in any replacement QSB stock that is purchased by the partner, as well as the adjusted basis of any replacement QSB stock that is purchased by a purchasing partnership and that is treated as the partner's replacement QSB stock must be reduced (in the order replacement QSB stock is acquired by the partner and purchasing partnership, as applicable) by the partner's distributive share of the gain on the sale of the selling partnership's QSB stock that is not recognized by the partner under paragraph (c)(1) of this section, or by the gain on a sale of QSB stock by the partner that is not recognized by the partner under section 1045, as applicable. If replacement QSB stock is purchased by the purchasing partnership, the purchasing partnership shall maintain its adjusted basis in the replacement QSB stock without regard to any basis adjustments required by this paragraph (c)(4)(ii). The eligible partner, however, shall in computing its distributive share of income, gain, loss and deduction from the purchasing partnership with respect to the replacement QSB stock take into account the variation between the adjusted basis in the QSB stock as determined under this paragraph (c)(4)(ii) and the adjusted basis determined without regard to this paragraph (c)(4)(ii). A partner must retain records setting forth the computation of this basis adjustment, the replacement QSB stock to which the adjustment has been made, and the date(s) on which such stock was acquired. See *Examples 7* and *8* of paragraph (i) of this section.

(iii) *Partner's basis in purchasing partnership interest*. A partner that treats the partner's interest in QSB stock purchased by a purchasing partnership as the partner's replacement QSB stock must reduce (in the order replacement QSB stock is acquired) the adjusted basis of the partner's interest in the purchasing partnership by the partner's distributive share of the gain on the sale of the selling partnership's QSB stock that is not recognized by the partner pursuant to paragraph (c)(1) of this section, or by the gain on a sale of QSB stock by the partner that is not recognized by the partner under section 1045, as applicable. Similarly, a partner of an upper-tier partnership that treats the partner's interest in QSB stock purchased by a lower-tier purchasing partnership as the partner's replacement QSB stock must reduce (in the order replacement QSB stock is acquired) the adjusted basis of the partner's interest in the upper-tier partnership by the partner's distributive share of the gain on the sale of the selling partnership's QSB stock that is not recognized by the partner pursuant to paragraph (c)(1) of this section, or by the gain on a sale of QSB stock by the partner that is not recognized by the partner under section 1045, as applicable.

(iv) *Increase in basis on sale of QSB stock by purchasing partnership.* A partner that recognizes gain under paragraph (c)(5) of this section must increase the adjusted basis of the partner's interest in the purchasing partnership under section 705(a)(1) by the amount of the gain recognized by that partner. Similarly, a partner in an upper-tier partnership that recognizes gain under paragraph (c)(5) of this section must increase the adjusted basis of the partner's interest in the upper-tier partnership under section 705(a)(1) by the amount of the gain recognized by that partner.

(5) *Partner recognition of gain.* At the time that either the partner or the purchasing partnership (whichever applies) sells or exchanges replacement QSB stock, the amount recognized by the partner is determined by taking into account the basis adjustments described in paragraph (c)(4)(ii) of this section. Similarly, a partner of an upper-tier partnership that owns an interest in a lower-tier partnership that holds replacement QSB stock must take into account the basis adjustments described in paragraph (c)(4)(ii) of this section in determining the amount recognized by the partner on a sale of the interest in the lower-tier partnership by the upper-tier partnership or the partner's distributive share of gain from the upper-tier partnership. See paragraph (e)(4) of this section for rules applicable to certain distributions of replacement QSB stock.

(d) *Nonrecognition limitation*—(1) *In general.* For purposes of this section, the amount of gain that an eligible partner does not recognize under paragraphs (b)(1) and (c)(1) of this section cannot exceed the nonrecognition limitation. Except as otherwise provided in paragraph (d)(2) of this section, the nonrecognition limitation is equal to the product of—

(i) The partnership's realized gain from the sale of the QSB stock, determined without regard to any basis adjustment under section 734(b) or section 743(b) (other than basis adjustments described in paragraph (b)(3)(ii) of this section); and

(ii) The eligible partner's smallest percentage interest in partnership capital as determined in paragraph (d)(2) of this section. See *Example 9* of paragraph (i) of this section.

(2) *Eligible partner's smallest percentage interest in partnership capital.* An eligible partner's smallest percentage interest in partnership capital is the eligible partner's percentage share of capital determined at the time of the acquisition of the QSB stock as adjusted prior to the time the QSB stock is sold to reflect any reduction in the capital of the eligible partner including a reduction as a result of a disproportionate capital contribution by other partners, a disproportionate capital distribution to the eligible partner or the transfer of an interest by the eligible partner, but excluding income and loss allocations.

(3) *Special rule for tiered partnerships.* For purposes of paragraph (d)(1)(ii) of this section, if an eligible partner is treated as owning an interest in a lower-tier purchasing partnership through an upper-tier partnership, the eligible partner's percentage interest in the purchasing partnership shall be proportionately adjusted to reflect the eligible partner's percentage interest in the upper-tier partnership.

(e) *Partnership distribution of QSB stock to a partner*—(1) *In general.* Subject to paragraphs (e)(2) and (3) of this section, in the case of a partnership distribution of QSB stock to a partner, the partner shall be treated for purposes of this section as—

(i) Having acquired such stock in the same manner as the partnership; and

(ii) Having held such stock during any continuous period immediately preceding the distribution during which it was held by the partnership. See *Examples 10* and *11* of paragraph (i) of this section.

(2) *Eligibility under section 1202(c).* Paragraph (e)(1) of this section does not apply unless all eligibility requirements with respect to QSB stock as defined in section 1202(c) are met by the distributing partnership with respect to its investment in QSB stock.

(3) *Distribution nonrecognition limitation*—(i) *Generally.* The amount of gain that an eligible partner does not recognize under this section on the sale of QSB stock that was distributed by the partnership to the partner cannot exceed the distribution nonrecognition

limitation. For this purpose, the distribution nonrecognition limitation is—

(A) The partner's section 1045 amount realized (determined under paragraph (e)(3)(ii) of this section); reduced by

(B) The partner's section 1045 adjusted basis (determined under paragraph (e)(3)(iii) of this section).

(ii) *Section 1045 amount realized*—(A) *QSB stock received in liquidation of partner's interest and in certain nonliquidating distributions.* If a partner receives QSB stock from the partnership in a distribution in liquidation of the partner's interest in the partnership or as part of a series of related distributions by the partnership in which the partnership distributes all of the partnership's QSB stock of a particular type, then the partner's section 1045 amount realized is the partner's amount realized from the sale of the distributed QSB stock, multiplied by a fraction—

(*1*) The numerator of which is the partner's smallest percentage interest in partnership capital determined under paragraph (e)(3)(ii)(B) of this section; and

(*2*) The denominator of which is the partner's percentage interest in that type of QSB stock immediately after the distribution (determined under paragraph (e)(3)(iv) of this section).

(B) *Partner's smallest percentage interest in partnership capital.* A partner's smallest percentage interest in partnership capital is the partner's percentage share of capital determined at the time of the acquisition of the QSB stock as adjusted prior to the time the QSB stock is distributed to the partner to reflect any reduction in the capital of the partner including a reduction as a result of a disproportionate capital contribution by other partners, a disproportionate capital distribution to the partner, or the transfer of a capital interest by the partner, but excluding income and loss allocations.

(C) *QSB stock received in other distributions.* If a partner receives QSB stock in a distribution from the partnership that is not described in paragraph (e)(3)(ii)(A) of this section, the partner's section 1045 amount realized is the partner's amount realized from the sale of the distributed QSB stock multiplied by the partner's smallest percentage interest in partnership capital determined under paragraph (e)(3)(ii)(B) of this section.

(iii) *Section 1045 adjusted basis*—(A) *QSB stock received in liquidation of partner's interest and in certain nonliquidating distributions.* If a partner receives QSB stock from the partnership in a distribution in liquidation of the partner's interest in the partnership or as part of a series of related distributions by the partnership in which the partnership distributes all of the partnership's QSB stock of a particular type, then the partner's section 1045 adjusted basis is the product of—

(*1*) The partnership's basis in all of the QSB stock of the type distributed (without regard to basis adjustments under section 734(b) or section 743(b), other than basis adjustments described in paragraphs (b)(3)(ii) and (c)(4)(ii) of this section);

(*2*) The partner's smallest percentage interest in partnership capital determined under paragraph (e)(3)(ii)(B) of this section; and

(*3*) The proportion of the distributed QSB stock that was sold by the partner.

(B) *QSB stock received in other distributions.* If a partner receives QSB stock in a distribution from the partnership that is not described in paragraph (e)(3)(iii)(A) of this section, the partner's section 1045 adjusted basis is the product of—

(*1*) The partnership's basis in the QSB stock sold by the partner (without regard to basis adjustments under section 734(b) or section 743(b), other than basis adjustments described in paragraphs (b)(3)(ii) and (c)(4)(ii) of this section); and

(*2*) The partner's smallest percentage interest in partnership capital determined under paragraph (e)(3)(ii)(B) of this section.

(iv) *Partner's percentage interest in distributed QSB stock.* For purposes of this paragraph (e)(3), a partner's percentage interest in a type of QSB stock immediately after a partnership distribution is the value (as of the date of the distribution) of the QSB stock distributed to the partner divided by the value (as of the date of the distribution) of all of

that type of QSB stock that was acquired by the partnership.

(v) *QSB stock of the same type.* For purposes of this paragraph (e)(3), QSB stock will be of the same type as the distributed QSB stock if it has the same issuer and the same rights and preferences as the distributed QSB stock and was acquired by the partnership at original issue.

(4) *Distribution of replacement QSB stock to a partner that reduces another partner's interest in the replacement QSB stock.* For purposes of this section, a partner must recognize gain upon a distribution of replacement QSB stock to another partner that reduces the partner's share of the replacement QSB stock held by a partnership. The amount of gain that the partner must recognize is determined based on the amount of gain that the partner would recognize upon a sale of the distributed replacement QSB stock for its fair market value on the date of the distribution but not to exceed the amount that was previously not recognized by the partner under section 1045 with respect to the distributed replacement QSB stock. Any gain recognized by a partner whose interest is reduced must be taken into account in determining the adjusted basis of the partner's interest in the partnership and also taken into account in determining the partnership's adjusted basis in the QSB stock distributed to another partner under paragraph (e)(3) of this section.

(f) *Contribution of QSB stock or replacement QSB stock to a partnership.* Section 721 applies to a contribution of QSB stock to a partnership. Except as provided in section 721(b), any gain that was not recognized by the taxpayer under section 1045 is not recognized when the taxpayer contributes QSB stock to a partnership in exchange for a partnership interest. Stock that is contributed to a partnership is not QSB stock in the hands of the partnership. See *Example 12* of paragraph (i) of this section.

(g) *Definitions.* For purposes of section 1045 and this section, the following terms are defined as follows:

(1) *Qualified small business stock.* The term *qualified small business stock* (QSB stock) has the meaning provided in section 1202(c). The term ''QSB stock'' does not include an interest in a partnership that purchases or holds QSB stock. See *Example 1* of paragraph (i) of this section.

(2) *Replacement QSB stock.* The term *replacement QSB stock* is any QSB stock purchased within 60 days beginning on the date of a sale of QSB stock.

(3) *Eligible partner*—(i) *In general.* Except as provided in paragraphs (e)(1), (g)(3)(ii), (iii) and (iv) of this section, an eligible partner with respect to QSB stock is a taxpayer other than a C corporation that holds an interest in a partnership on the date the partnership acquires the QSB stock and at all times thereafter for more than 6 months until the partnership sells or distributes the QSB stock.

(ii) *Acquisition by gift or at death.* For purposes of paragraph (g)(3)(i) of this section, a taxpayer who acquires from a partner (other than a C corporation) by gift or at death an interest in a partnership that holds QSB stock is treated as having held the acquired interest in the partnership during the period the partner (other than a C corporation) held the interest in the partnership.

(iii) *Tiered partnership.* For purposes of paragraph (g)(3)(i) of this section, if a partnership (upper-tier partnership) holds an interest in another partnership (lower-tier partnership) that holds QSB stock, then the upper-tier partnership's ownership of the lower-tier partnership is disregarded and each partner of the upper-tier partnership is treated as owning the interest in the lower-tier partnership directly. The partner of the upper-tier partnership is treated as owning the interest in the lower-tier partnership during the period in which both—

(A) The partner of the upper-tier partnership held an interest in the upper-tier partnership; and

(B) The upper-tier partnership held an interest in the lower-tier partnership. See *Examples 3* and *4* of paragraph (i) of this section.

(iv) *Multiple tiers of partnerships.* Principles similar to those described in paragraph (g)(3)(iii) of this section apply where a taxpayer holds an interest in a lower-tier partnership through multiple tiers of partnerships.

(4) *Month(s).* For purposes of this section, the term *month(s)* means a period commencing on the same numerical day of any calendar month as the day on which the QSB stock is sold and ending with the close of the day preceding the numerically corresponding day of the succeeding calendar month or, if there is no corresponding day, with the last day of the succeeding calendar month.

(h) *Reporting and election rules*—(1) *Time and manner of making election.* A partnership making an election under section 1045 (as described under paragraph (b)(1) of this section) must do so on the partnership's timely filed (including extensions) Federal income tax return for the taxable year during which the sale of QSB stock occurs. A partner making an election under section 1045 (as described under paragraph (c)(1) of this section) must do so on the partner's timely filed (including extensions) Federal income tax return for the taxable year during which the partner's distributive share of the partnership's gain from the sale of the QSB stock is taken into account by such partner under section 706. In addition, a partnership or partner making an election under section 1045 must make such election in accordance with the applicable forms and instructions.

(2) *Purchases, distributions, and sales of QSB stock or replacement QSB stock by partnerships.* A partnership that purchases, distributes to a partner, or sells or exchanges QSB stock or replacement QSB stock must provide information to the Commissioner and to the partnership's partners to the extent provided by the applicable forms and instructions.

(3) *Nonrecognition of gain by eligible partners.* An eligible partner that does not recognize gain under section 1045 must provide information to the Commissioner to the extent provided by the applicable forms and instructions.

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

Example 1. Sale of a partnership interest. On January 1, 2008, A, an individual, X, a C corporation, and Y, a C corporation, form PRS, a partnership. A, X, and Y each contribute $250 to PRS and agree to share all partnership items equally. PRS purchases QSB stock for $750 on February 1, 2008. On November 4, 2008, A sells A's interest in PRS for $500, realizing $250 of capital gain. Under paragraph (g)(1) of this section, an interest in a partnership that holds QSB stock is not treated as QSB stock. Therefore, the sale of an interest in a partnership that holds QSB stock is not treated as a sale of QSB stock, and A may not elect to apply section 1045 with respect to A's $250 gain from the sale of A's interest in PRS.

Example 2. Election by partner; replacement by partnership. (i) Assume the same facts as in *Example 1*, except that A does not sell A's interest in PRS. Instead, PRS sells the QSB stock (QSB1 stock) for $1,500 on November 3, 2008. PRS realizes $750 of gain from the sale of the QSB1 stock (none of which is treated as ordinary income) and allocates $250 of gain to each of A, X, and Y. PRS does not make a section 1045 election. On November 30, 2008, A contributes $500 to ABC, a partnership, in exchange for a 10 percent interest in ABC. ABC then purchases QSB stock (QSB2 stock) for $5,000 on December 1, 2008. ABC has no other assets. A makes an election under paragraph (c)(1) of this section and treats A's percentage interest in ABC's QSB2 stock as replacement QSB stock under paragraph (c)(1)(iii) of this section with respect to the $250 gain PRS allocated to A. Under paragraph (c)(3) of this section, A's share of the cost of QSB2 stock purchased by ABC is $500 (A's reasonably expected income and gain with respect to QSB2 stock, or 10 percent multiplied by the cost of the QSB2 stock, $5,000). Under paragraph (c)(1)(iii) of this section, A will not recognize the $250 gain PRS allocated to A, because A's share of the amount realized by PRS, $500 (the total amount realized by the partnership on the sale of the QSB1 stock ($1,500) multiplied by A's share of the gain from the sale of the QSB1 stock ($250) over the total gain realized by the partnership on the sale of the QSB1 stock ($750)), does not exceed A's share of ABC's cost of the QSB2 stock acquired by ABC, $500. Under paragraph (c)(4)(ii) of this section, A must reduce A's share of ABC's basis in the QSB2 stock by $250. Under paragraph (c)(4)(iii) of this section, A must reduce A's basis in A's interest in ABC by $250. Under paragraph (c)(4)(i) of this section, A's basis in A's interest in PRS is increased by $250.

(ii) Assume the same facts as in paragraph (i) of this *Example 2*, except that A does not contribute $500 to ABC in exchange for a partnership interest. Instead, on November 30, 2008, EFG, a partnership in which A has an existing 10 percent partnership interest, purchases QSB stock for $5,000. Under paragraph (c)(1) of this section, A may treat A's 10 percent interest in EFG's QSB stock as replacement QSB stock with respect to the $250 of gain PRS allocated to A.

(iii) Assume the same facts as in paragraph (i) of this *Example 2*, except that ABC owns QSB stock that ABC purchased on November 10, 2008, and ABC does not purchase QSB stock on December 1, 2008. Under paragraph (c)(1) of this section, ABC is not a purchasing partnership with respect to A for the QSB stock ABC purchased on November 10, 2008. A may not treat A's percentage interest in ABC's QSB stock as replacement QSB stock to defer the $250 gain PRS allocated to A, because A acquired its interest in ABC after ABC acquired the QSB stock.

(iv) Assume the same facts as in paragraph (i) of this *Example 2*, except that ABC sells QSB2 stock on July 30, 2009, for $5,000. ABC realizes no gain or loss on the sale of QSB2 stock. A desires to continue to rollover the $250 gain from the sale of QSB1 stock. Under paragraph (c)(2)(ii)(A) of this section, A's share of the amount realized is $500, which was A's share of the amount realized on the prior sale of QSB1 stock. Accordingly, A must elect to apply section 1045 and purchase $500 of replacement QSB stock either directly or through a purchasing partnership to continue to defer the $250 gain from the sale of QSB1 stock.

Example 3. Tiered partnerships; partnership election. (i) On January 1, 2008, A, an individual, and B, an individual, each contribute $500 to UTP (upper-tier partnership) for equal partnership interests. On February 1, 2008, UTP and C, an individual, each contribute $1,000 to LTP (lower-tier partnership) for equal partnership interests. On March 1, 2008, LTP purchases QSB stock for $500. On April 1, 2008, D, an individual, joins UTP by contributing $500 to UTP for a ⅓ interest in UTP. On December 1, 2008, LTP sells the QSB stock for $2,000. Under paragraph (g)(3)(iii) of this section, A, B, and D are treated as owning an interest in LTP during the period in which each of the partners held an interest in UTP and UTP held an interest in LTP. Therefore, under paragraphs (g)(3)(i) and (iii) of this section, A and B are eligible partners, and D and UTP are not eligible partners with respect to the QSB stock sold by LTP. Under paragraph (g)(3)(i) of this section, C is also an eligible partner with respect to the QSB stock sold by LTP.

(ii) Assume the same facts as in paragraph (i) of this *Example 3*. LTP realizes a gain of $1,500 on the December 1, 2008, sale of QSB stock. LTP allocates $750 of gain to each of UTP and C. UTP, in turn, allocates $250 (of the $750 of gain allocated to UTP) to each of A, B, and D. LTP makes a section 1045 election. On January 1, 2009, LTP purchases replacement QSB stock for $2,000. Under paragraph (b)(5)(ii) of this section, D notifies UTP that it recognizes $250 of gain and UTP notifies LTP. Because A, B, and C are eligible partners with respect to the QSB stock sold by LTP, A and B may each defer $250 of LTP's section 1045 gain and C may defer $750 of LTP's section 1045 gain. LTP must decrease its basis in the replacement QSB stock by the $750 of partnership section 1045 gain that was allocated to C and by $500 of the partnership section 1045 gain that was allocated to UTP. These basis reductions are with respect to UTP (A and B) and C only. Under paragraph (b)(3)(ii)(B) of this section, the basis of UTP's interest in LTP attributable to the LTP's replacement QSB stock must be segregated and allocated to A and B. In addition, A and B each have a $250 negative basis adjustment in their respective interests in UTP. If UTP sells its interest in LTP for $1,250, A and B would each recognize $250 of gain from the sale of the LTP interest. D would not recognize any gain or loss from the sale.

Example 4. Tiered partnerships; partner election. (i) On January 1, 2008, A, an individual, and X, a C corporation, form UTP, a partnership. A and X each contribute $250 to UTP and agree to share all partnership items equally. Also, on January 1, 2008, UTP and Y, a C corporation, form LTP, a partnership. UTP and Y contribute $500 and $250, respectively, to LTP. UTP and Y agree to share all partnership items equally. LTP purchases QSB stock for $750 on February 1, 2008. On November 3, 2008, LTP sells the QSB stock for $1,500. LTP realizes $750 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates $250 gain to Y and $500 gain to UTP. Of the $500 gain allocated to UTP from the sale of QSB stock, $250 is allocated to A and $250 is allocated to X. LTP purchases replacement QSB stock (replacement QSB1 stock) for $1,350 on December 15, 2008. LTP does not make an election under section 1045. Under the rules provided in paragraph (c) of this section, A makes an election under section 1045 on its timely filed return for the taxable year for which the distributive share of gain from the sale of QSB stock is taken into account by A under section 706. Under paragraph (c)(1)(iii) of this section, A treats A's interest in replacement QSB1 stock as replacement stock with respect to A's distributive share of LTP's section 1045 gain. On March 30, 2009, LTP sells replacement QSB1 stock for $1,650. LTP realizes $300 of gain from the sale of replacement QSB1 stock (none of which is treated as ordinary income) and allocates $100 to Y and $200 to UTP.

(ii) Under paragraph (c)(1)(iii) of this section, A must recognize its distributive share of gain from LTP's sale of QSB stock ($250) only to the extent of the greater of A's distributive share of LTP's gain from the sale of QSB stock that is treated as ordinary income ($0) or the amount by which A's share of the amount realized by LTP's sale of QSB stock exceeds A's share of LTP's cost of the replacement QSB1 stock, $50 (⅓ of $1,500, or $500, minus ⅓ of $1,350, or $450). Because Y is

not an eligible partner of LTP under paragraph (g)(3) of this section, Y must recognize its $250 distributive share of partnership gain from the sale of the QSB stock. Also, X is not an eligible partner under paragraph (g)(3) of this section, and it must recognize its $250 distributive share of gain from UTP attributable to UTP's distributive share of $500 of LTP's gain from the sale of QSB stock.

(iii) Under section 705(a)(1), the adjusted basis of Y's interest in LTP is increased by $250, and the adjusted basis of UTP's interest in LTP is increased by $500. Under section 705(a)(1), the adjusted basis of X's interest in UTP is increased by $250, and the adjusted basis of A's interest in UTP is increased by $250. However, under paragraph (c)(4)(iii) of this section, the adjusted basis of A's interest in UTP is reduced by the $200 of partnership section 1045 gain that was not recognized by A.

(iv) Under paragraph (c)(4)(ii) of this section, the LTP's adjusted basis in replacement QSB1 stock is reduced by the $200 of gain from the sale of QSB stock that is not recognized by A, as a result of A's election under section 1045. A must retain records setting forth the computation of this basis adjustment, the replacement QSB stock to which the adjustment is made, and dates the stock was acquired. LTP's adjusted basis in the replacement QSB1 stock is maintained without regard to the eligible partner's adjustment provided in paragraph (c)(4)(ii) of this section.

(v) On the sale of replacement QSB1 stock, LTP realizes a gain of $300, $100 of which is allocated to Y and $200 of which is allocated to UTP. UTP allocates $100 of this gain to A. Under paragraph (c)(5) of this section, in determining A's amount recognized upon the sale of replacement QSB1 stock by LTP, A must take into account A's basis adjustment of $200. Accordingly, A recognizes a total gain of $300 upon the sale of replacement QSB1 stock, absent an additional section 1045 election by A or LTP. Under paragraph (c)(4)(iv) of this section, the adjusted basis of A's interest in UTP is increased by $300 under section 705(a)(1).

(vi) Assume the same facts as in paragraph (i) of this *Example 4*, except that UTP sells its entire interest in LTP on March 30, 2009, for $1,200. UTP realizes a gain of $200 on the sale of its interest in LTP ($1,200 amount realized less $1,000 adjusted basis) and allocates $100 of this gain to A. Under paragraph (c)(5) of this section, in determining A's amount recognized upon the sale of UTP's interest in LTP, A must take into account A's basis adjustment of $200. Accordingly, A recognizes a total gain of $300 upon the sale of the interest in LTP. Under paragraph (c)(4)(iv) of this section, the adjusted basis in A's interest in UTP is increased by $300 under section 705(a)(1).

Example 5. Partnership sale of QSB stock and purchase and sale of replacement QSB stock. (i) On January 1, 2008, A, an individual, X, a C corporation, and Y, a C corporation, form PRS, a partnership. A, X, and Y each contribute $250 to PRS and agree to share all partnership items equally. PRS purchases QSB stock for $750 on February 1, 2008. On November 3, 2008, PRS sells the QSB stock for $1,500. PRS realizes $750 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates $250 of gain to each of A, X, and Y. PRS purchases replacement QSB stock (replacement QSB1 stock) for $1,350 on December 15, 2008. On its timely filed return for the taxable year during which the sale of the QSB stock occurs, PRS makes an election to apply section 1045. A does not make an election to apply section 1045 with respect to the November 3, 2008, sale of QSB stock. PRS knows that X and Y are C corporations. On March 30, 2009, PRS sells replacement QSB1 stock for $1,650. PRS realizes $300 of gain from the sale of replacement QSB1 stock (none of which is treated as ordinary income) and allocates $100 of gain to each of A, X, and Y. A does not make an election to apply section 1045 with respect to the March 30, 2009, sale of replacement QSB1 stock.

(ii) Under paragraph (b)(1) of this section, the partnership section 1045 gain from the November 3, 2008, sale of QSB stock is $600 ($750 gain less $150 ($1,500 amount realized on the sale of QSB stock less $1,350 cost of replacement QSB1 stock)). This amount must be allocated among the partners in the same proportions as the entire gain from the sale of QSB stock is allocated to the partners, ⅓ ($200) to A, ⅓ ($200) to X, and ⅓ ($200) to Y.

(iii) Because neither X nor Y is an eligible partner under paragraph (g)(3) of this section, X and Y must each recognize its $250 distributive share of partnership gain from the sale of QSB stock. Because A is an eligible partner under paragraph (g)(3) of this section, A may defer recognition of A's $200 distributive share of partnership section 1045 gain. A is not required to separately elect to apply section 1045. A must recognize A's remaining $50 distributive share of the partnership's gain from the sale of QSB stock.

(iv) Under section 705(a)(1), the adjusted bases of X's and Y's interests in PRS are each increased by $250. Under section 705(a)(1) and paragraph (b)(3)(i) of this section, the adjusted basis of A's interest in PRS is not increased by the $200 of partnership section 1045 gain that was not recognized by A, but is increased by A's remaining $50 distributive share of gain.

(v) PRS must decrease its basis in the replacement QSB1 stock by the $200 of partnership section 1045 gain that was allocated to A. This basis reduction is a reduction with

respect to A only. PRS then adjusts A's distributive share of gain from the sale of replacement QSB1 stock to reflect the effect of A's basis adjustment under paragraph (b)(3)(ii) of this section. In accordance with the principles of §1.743–1(j)(3), the amount of A's gain from the March 30, 2009, sale of replacement QSB1 stock in which A has a $200 negative basis adjustment equals $300 (A's share of PRS' gain from the sale of replacement QSB1 stock ($100), increased by the amount of A's negative basis adjustment for replacement QSB1 stock ($200)). Accordingly, upon the sale of replacement QSB1 stock, A recognizes $300 of gain, and X and Y each recognize $100 of gain.

(vi) Assume the same facts as in paragraph (i) of this *Example 5*, except that PRS purchases replacement QSB stock (replacement QSB2 stock) on April 15, 2009, for $1,150 and PRS makes an election to apply section 1045 with respect to the March 30, 2009, sale of replacement QSB1 stock. Under paragraph (b)(3)(ii)(A) of this section, PRS' $200 basis adjustment in QSB1 stock relating to the November 3, 2008, sale of QSB stock carries over to the basis adjustment for QSB2 stock. This basis adjustment is an adjustment with respect to A only. The $200 basis adjustment is reduced by A's distributive share of the excess of $500 (the greater of the amount determined under paragraph (b)(1)(i), $0, or (ii) of this section, $500 ($1,650 amount realized on the sale of QSB1 stock less $1,150 cost of replacement QSB2 stock)) over $300 (PRS' gain from the sale of QSB1 stock), or $67 ($200 ($500 minus $300) divided by 3). Under paragraph (b)(3)(ii)(A), A must account for the $67 excess amount that reduces PRS' basis adjustment in QSB2 stock as gain in accordance with §1.743–1(j)(3). Therefore, A now has a $133 negative basis adjustment with respect to replacement QSB2 stock (($200) negative basis adjustment from the November 3, 2008, sale of QSB stock plus $67 positive basis adjustment from the March 30, 2009, sale of QSB1 stock). A also recognizes the $100 of gain allocated by PRS to A from the March 30, 2009, sale of replacement QSB1 stock for total gain recognition of $167 ($100 plus $67).

Example 6. Partnership sale of QSB stock; election by eligible partner; replacement QSB stock purchased by purchasing partnership. (i) Assume the same facts as in *Example 5* except that PRS does not make an election under section 1045 with respect to the sale of either the QSB stock on November 3, 2008, or the QSB1 stock on March 30, 2009. However, A makes an election under section 1045 with respect to the sale of QSB stock and treats the purchase of QSB1 stock on December 15, 2008, by PRS, as the purchase of replacement QSB stock. Additionally, A makes an election under section 1045 with respect to the sale of QSB1 stock and treats the purchase of QSB2 stock on April 15, 2009, by PRS, as the purchase of replacement QSB stock.

(ii) A's distributive share of gain from the November 3, 2008, sale of QSB stock is $250 (A's ⅓ interest in $750 of total PRS gain). Under paragraph (c)(1)(iii) of this section, A must recognize only $50 of A's distributive share of PRS' gain of $250, that is the excess of A's share of the amount realized on the sale of QSB stock, or $500 (the total amount realized by PRS on the sale of QSB stock ($1,500) multiplied by A's share of the gain from the sale of QSB stock ($250) over the total gain realized by PRS on the sale of QSB stock ($750)), minus A's share of PRS' cost of QSB1 stock, or $450 (⅓ of $1,350). Under section 705(a)(1) and paragraph (c)(4)(i) of this section, A's adjusted basis in its interest in PRS is increased by $250. However, under paragraph (c)(4)(iii) of this section, because PRS is a purchasing partnership, A's adjusted basis of its interest in PRS is then reduced by the deferred gain of $200. Also under paragraph (c)(4)(ii) of this section, PRS' adjusted basis in QSB1 stock is reduced by the gain not recognized of $200 and A must take into account such adjusted basis in computing A's income, gain, loss or deduction with respect to QSB1 stock. A must retain records setting forth the computation of this basis adjustment, the replacement QSB stock to which the adjustment is made, and dates the stock was acquired.

(iii) A's distributive share of gain from the March 30, 2009, sale of QSB1 stock is $100 (A's ⅓ interest in $300 of total PRS gain) and under paragraph (c)(5) of this section, A must take into account A's $200 basis adjustment with respect to the QSB1 stock that was sold. Accordingly, A's total gain from the sale of QSB1 stock is $300. Under paragraph (c)(1)(iii) of this section, A must recognize only $167 of A's total gain of $300, that is, the excess of A's share of the amount realized on the sale of QSB1 stock, or $550 (the total amount realized by PRS on the sale of QSB1 stock ($1,650) multiplied by A's share of the gain from the sale of QSB1 stock ($100) over the total gain realized by PRS on the sale of QSB1 stock ($300)) minus A's share of PRS' cost of QSB2 stock, or $383 (⅓ of $1,150). Under section 705(a)(1), A's adjusted basis in A's interest in PRS is increased by A's $100 distributive share of gain from the sale of QSB1 stock. Under paragraph (c)(4)(iv) of this section, A's adjusted basis of A's interest in PRS is increased by the additional $67 of gain recognized under paragraph (c)(5) of this section. Also, under paragraph (c)(4)(ii) of this section, PRS' adjusted basis in QSB2 stock is reduced by the gain not recognized of $133 ($300 minus $167) and A must take into account such adjusted basis in computing A's income, gain, loss or deduction with respect to QSB2 stock. A must retain records setting forth the computation of this basis adjustment, the replacement QSB stock to which the adjustment is made, and dates the stock was acquired.

Example 7. Partnership sale of QSB stock and partner purchase of replacement QSB stock. (i) Assume the same facts as in paragraph (i) of *Example 5*, except that PRS does not make an election under section 1045 with respect to the sale of the QSB stock and does not purchase replacement QSB stock. On November 30, 2008, A, an eligible partner under paragraph (g)(3) of this section, purchases replacement QSB stock for $500. A elects pursuant to paragraph (c) of this section to apply section 1045 on A's timely filed return for the taxable year that A is required to include A's distributive share of PRS' gain from the sale of the QSB stock.

(ii) Under paragraph (c)(2) of this section, A's share of the amount realized from PRS' sale of the QSB stock is $500 (the total amount realized by the partnership on the sale of the QSB stock ($1,500) multiplied by A's share of the gain from the sale of the QSB stock ($250) over the total gain realized by the partnership on the sale of the QSB stock ($750)). Because A purchased, within 60 days of PRS' sale of the QSB stock, replacement QSB stock for a cost equal to A's share of the partnership's amount realized on the sale of the QSB stock, and because A made an election pursuant to paragraph (c) of this section to apply section 1045, A defers recognition of A's $250 distributive share of gain from PRS' sale of the QSB stock. Under section 705(a)(1) and paragraph (c)(4)(i) of this section, the adjusted basis of A's interest in PRS is increased by $250. Under paragraph (c)(4)(ii) of this section, A's adjusted basis in the replacement QSB stock is $250 ($500 cost minus $250 nonrecognition amount).

Example 8. Partial replacement by partnership; partial replacement by partner. (i) On January 1, 2008, A, an individual, and X, a C corporation, form PRS, a partnership. A and X each contribute $500 to PRS and agree to share all partnership items equally. PRS purchases QSB stock on February 1, 2008, for $1,000 and subsequently sells the QSB stock on January 31, 2010, for $3,000. PRS realizes $2,000 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates $1,000 of gain to each of A and X. On February 10, 2010, PRS purchases replacement QSB stock for $2,200. On March 20, 2010, A purchases replacement QSB stock for $400. PRS makes an election to apply section 1045 under paragraph (b)(1) of this section with respect to the partnership section 1045 gain from the sale of QSB stock and A does not opt out of PRS' section 1045 election under paragraph (b)(4) of this section. Also, A makes an election under paragraph (c)(1) of this section with respect to the remaining gain from the sale of the QSB stock.

(ii) Under paragraph (b)(1) of this section, partnership section 1045 gain is $1,200 ($2,000 less $800 ($3,000 amount realized on the sale of the QSB stock minus $2,200 cost of the replacement QSB stock)). This amount is allocated among the partners in the same proportions as the entire gain from the sale of the QSB stock is allocated to the partners, ½ to A ($600), and ½ to X ($600). Because A is an eligible partner, A defers recognition of A's $600 distributive share of partnership section 1045 gain.

(iii) A also made an election under section 1045 and purchased, within 60 days of PRS' sale of the QSB stock, replacement QSB stock for $400. Therefore, under paragraph (c)(1) of this section, A may defer a portion of A's distributive share of the remaining gain from the partnership's sale of the QSB stock. A must recognize that remaining gain to the extent that A's share of the amount realized by PRS on the sale of the QSB stock (excluding the cost of the QSB stock that was replaced by PRS) exceeds the cost of the replacement QSB stock purchased by A during the 60-day period following the sale of the QSB stock. The amount realized by PRS on the sale of the QSB stock (excluding the cost of the QSB stock that was replaced by PRS) is $800 ($3,000 minus $2,200). Under paragraph (c)(2) of this section, A's share of that amount realized is $400 ($1,000 (A's share of the realized gain from the sale of the QSB stock) ÷ $2,000 (PRS total realized gain from the sale of the QSB stock) multiplied by $800). Because the replacement QSB stock purchased by A cost $400, A defers recognition of all of the remaining gain from the sale of the QSB stock.

(iv) The adjusted basis of A's interest in PRS is not increased by the $600 gain that was not recognized pursuant to paragraph (b)(1) of this section, but is increased by the $400 gain that was not recognized pursuant to paragraph (c)(1) of this section. See paragraphs (b)(3)(i) and (c)(4)(i) of this section. PRS must decrease its basis in the replacement QSB stock by the $600 of partnership section 1045 gain that was allocated to A. See paragraph (b)(3)(ii) of this section. A must decrease A's basis in the replacement QSB stock purchased by A by the $400 not recognized pursuant to paragraph (c)(1) of this section. See paragraph (c)(4)(ii) of this section.

Example 9. Change in partner's interest in partnership while partnership holds QSB stock. (i) On January 1, 2008, A, an individual, and X, a C corporation, form PRS, a partnership. A and X each contribute $500 to PRS and agree to share all partnership items equally. PRS purchases QSB stock on February 1, 2008, for $1,000. On August 2, 2008, A sells a 25 percent interest in PRS to Z. On July 10, 2009, A repurchases the 25 percent interest from Z for $500. PRS makes a timely election under section 754 for the 2008 taxable year. Under section 743(b), A has a positive basis adjustment of $250. On January 31, 2011, PRS sells the QSB stock for $3,000. PRS realizes $2,000 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates $1,000 of gain to each of A and

X. On February 10, 2010, PRS purchases replacement QSB stock for $3,000. PRS makes an election to apply section 1045 under paragraph (b)(1) of this section with respect to the partnership section 1045 gain from the sale of QSB stock.

(ii) Of the $2,000 of realized gain from the sale of the QSB stock, PRS allocates $1,000 to A and $1,000 to X. However, A has a positive basis adjustment of $250 under section 743(b) as a result of the purchase of the 25 percent interest in PRS from Z; therefore, A's share of the gain is reduced to $750. Because A is an eligible partner under paragraph (g)(3) of this section, A may defer recognition of A's distributive share of gain from the sale of the QSB stock subject to the nonrecognition limitation described in paragraph (d) of this section. The smallest percentage interest that A held in PRS capital during the time that PRS held the QSB stock is 25 percent. Under the nonrecognition limitation, A may not defer more than 25 percent of the partnership gain realized from the sale of the QSB stock (determined without regard to any basis adjustment under section 734(b) or section 743(b), other than a basis adjustment described in paragraph (b)(3)(ii) of this section). Because the partnership's realized gain determined without regard to A's basis adjustment under section 743(b) is $2,000, A may defer recognition of $500 (25 percent of $2,000) of the gain from the sale of the QSB stock. A must recognize the remaining $250 of that gain.

Example 10. Sale by partner of QSB stock received in a liquidating distribution. (i) On January 1, 2008, A, an individual, and X, a C corporation, form PRS, a partnership. A and X each contribute $1,500 to PRS and agree to share all partnership items equally. PRS purchases QSB stock on February 1, 2008, for $3,000. On May 1, 2008, when the QSB stock has appreciated in value to $4,000, A contributes $1,000 to PRS, increasing A's interest in PRS capital to 60 percent. On June 1, 2011, when the QSB stock is still worth $4,000, PRS makes a liquidating distribution of $3,000 worth of QSB stock to A. Under section 732, A's basis in the distributed QSB stock is $2,500. A sells the QSB stock on August 4, 2011, for $6,000, realizing a gain of $3,500 (none of which is treated as ordinary income). A purchases replacement QSB stock on August 30, 2011, for $5,500, and makes an election under section 1045 with respect to the August 4, 2011, sale of QSB stock.

(ii) A is an eligible partner under paragraph (g)(3) of this section. Therefore, under paragraph (e)(1) of this section, A is treated as having acquired the distributed QSB stock in the same manner as PRS and as having held the QSB stock since February 1, 2008, its original issue date. Because A purchased, within 60 days of A's sale of the QSB stock, replacement QSB stock, A is eligible to defer a portion of A's gain from the sale of the QSB stock. A must recognize gain, however, to the extent that A's amount realized on the sale of the QSB stock, $6,000, exceeds the cost of the replacement QSB stock purchased by A during the 60-day period beginning on the date of the sale of the QSB stock, $5,500. Accordingly, A must recognize $500 of the gain from the sale of the QSB stock. A defers recognition of the remaining $3,000 of gain to the extent that such gain does not exceed the distribution nonrecognition limitation under paragraph (e)(3) of this section.

(iii) Under paragraph (e)(3)(i) of this section, A's nonrecognition limitation with respect to the sale of the QSB stock is A's section 1045 amount realized with respect to the stock, reduced by A's section 1045 adjusted basis with respect to the stock. A's amount realized from the sale is the product of A's amount realized from the sale, $6,000; and a fraction—

(*1*) The numerator of which is A's smallest percentage interest in PRS capital with respect to such stock, 50 percent; and

(*2*) The denominator of which is A's percentage interest in that type of partnership QSB stock immediately after the distribution, 75 percent (the value of the stock distributed to A, $3,000, divided by the value of all QSB stock of that type acquired by PRS, $4,000).

(iv) Therefore, A's section 1045 amount realized is $4,000 ($6,000 multiplied by 50/75). Because PRS distributed the QSB stock to A in liquidation of A's interest in PRS, A's section 1045 adjusted basis is the product of PRS' basis in all of the QSB stock of the type distributed, $3,000; A's smallest percentage interest in PRS capital with respect to QSB stock of the type distributed, 50 percent; and the percentage of the distributed QSB stock that was sold by A, 100 percent. Therefore, A's section 1045 adjusted basis is $1,500 (the product of $3,000, 50 percent, and 100 percent)) and A's nonrecognition limitation amount on the sale of the QSB stock is $2,500 ($4,000 section 1045 amount realized minus $1,500 section 1045 adjusted basis). Accordingly, A defers recognition of $2,500 of the remaining $3,000 gain from the sale of the QSB stock and must recognize $500 of the remaining $3,000 gain. Accordingly, A's total gain recognized from the sale of the QSB stock is $1,000.

(v) A's basis in the replacement QSB stock is $3,000 (cost of the replacement QSB stock, $5,500, reduced by the gain not recognized under section 1045, $2,500).

Example 11. Sale by partner of QSB stock received in a nonliquidating distribution. (i) The facts are the same as in *Example 10*, except that, on June 1, 2011, PRS distributes only $2,000 of the QSB stock to A, reducing A's interest in PRS capital from 60 percent to 33 percent. PRS' basis in the distributed QSB stock is $1,500. On November 1, 2011, A sells for $2,500 the QSB stock distributed by PRS

to A and purchases, within 60 days of the date of sale of the QSB stock, replacement QSB stock for $2,500. A makes a timely election to apply section 1045 with respect to A's sale of the distributed QSB stock.

(ii) Under section 732, A's basis in the distributed QSB stock is $1,500. Therefore, A realizes a gain on the sale of the distributed QSB stock of $1,000. Because A made an election to apply section 1045 to the sale, and because A purchased, within 60 days of A's sale of the QSB stock, replacement QSB stock at a cost equal to the amount realized on the sale of the distributed QSB stock, A defers recognition of the gain from the sale of the QSB stock to the extent that such gain does not exceed the distribution nonrecognition limitation.

(iii) Under paragraph (e)(3) of this section, the nonrecognition limitation with respect to A's sale of the QSB stock is A's section 1045 amount realized reduced by A's section 1045 adjusted basis. Because PRS did not distribute all of the particular type of QSB stock and the distribution of the QSB stock to A was not in liquidation of A's interest in PRS, under paragraph (e)(3)(ii)(C) of this section A's section 1045 amount realized is $1,250 (A's amount realized from the sale of the distributed QSB stock, $2,500, multiplied by A's smallest percentage interest in PRS capital with respect to such stock, 50 percent). Under paragraph (e)(3)(iii)(B) of this section, A's section 1045 adjusted basis is the product of the partnership's basis in the QSB stock sold by the partner, $1,500, and A's smallest percentage interest in the partnership capital with respect to such stock, 50 percent. Therefore, A's section 1045 adjusted basis is $750 (50 percent of $1,500), and A's nonrecognition limitation amount on the sale of the QSB stock is $500 ($1,250 section 1045 amount realized minus $750 section 1045 adjusted basis). As this amount is less than the amount of gain that A is eligible to defer under section 1045, $1,000, A defers recognition of only $500 of the gain from the sale of the QSB stock. A must recognize the remaining $500 of that gain.

(iv) A's basis in the replacement QSB stock is $2,000 (cost of the replacement QSB stock, $2,500, reduced by the gain not recognized under section 1045, $500).

Example 12. Contribution of replacement QSB stock to a partnership. (i) On January 1, 2008, A, an individual, B, an individual, and X, a C corporation, form PRS, a partnership. A, B, and X each contribute $250 to PRS and agree to share all partnership items equally. On February 1, 2008, PRS purchases QSB stock for $750. PRS sells the QSB stock on November 3, 2008, for $1,050. PRS realizes $300 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates $100 of gain to each of its partners. PRS informs the partners that it does not intend to make an election under section 1045 with respect to the sale of the QSB stock. Each partner's share of the amount realized from the sale of the QSB stock is $350. On November 30, 2008, A, an eligible partner within the meaning of paragraph (g)(3) of this section, purchases replacement QSB stock for $350 and makes a section 1045 election under paragraph (c)(1) of this section. Subsequently, A transfers the replacement QSB stock to ABC, a partnership, in exchange for an interest in ABC.

(ii) Because A purchased within 60 days of PRS' sale of the QSB stock, replacement QSB stock for a cost equal to A's share of the partnership's amount realized on the sale of the QSB stock, and because A made a valid election to apply section 1045 with respect to A's share of the gain from PRS' sale of the QSB stock, A does not recognize A's $100 distributive share of the gain from PRS' sale of the QSB stock. Before the contribution of the replacement QSB stock to ABC, A's adjusted basis in the replacement QSB stock is $250 ($350 cost minus $100 nonrecognition amount). A does not recognize gain upon the contribution of QSB stock to ABC under section 721(a). Upon the contribution of the replacement QSB stock to ABC, A's basis in the ABC partnership interest is $250, and ABC's basis in the replacement QSB stock is $250. However, the replacement QSB stock does not qualify as QSB stock in ABC's hands. Neither A nor ABC will be eligible to defer gain under section 1045 on a subsequent sale of the replacement QSB stock.

(j) *Effective date/applicability—In general.* This section applies to sales of QSB stock on or after August 14, 2007.

[T.D. 9353, 72 FR 45349, Aug. 14, 2007, as amended by T.D. 9353, 72 FR 57487, Oct. 10, 2007]

SPECIAL RULES

§ 1.1051–1 Basis of property acquired during affiliation.

(a)(1) The basis of property acquired by a corporation during a period of affiliation from a corporation with which it was affiliated shall be the same as it would be in the hands of the corporation from which acquired. This rule is applicable if the basis of the property is material in determining tax liability for any year, whether a separate return or a consolidated return is made in respect of such year. For the purpose of this section, the term *period of affiliation* means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto), but does not include any taxable year beginning on or

after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example: The X Corporation, the Y Corporation, and the Z Corporation were affiliated for the taxable year 1920. During that year the X Corporation transferred assets to the Y Corporation for $120,000 cash, and the Y Corporation in turn transferred the assets during the same year to the Z Corporation for $130,000 cash. The assets were acquired by the X Corporation in 1916 at a cost of $100,000. The basis of the assets in the hands of the Z Corporation is $100,000.

(b) The basis of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made or was required under the regulations governing the making of consolidated returns, shall be determined in accordance with such regulations. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made or is required under the regulations governing the making of consolidated returns, shall be adjusted in respect of any items relating to such period in accordance with such regulations.

(c) Except as otherwise provided in the regulations promulgated under section 1502 of the Internal Revenue Code of 1954 or the regulations under section 141 of the Internal Revenue Code of 1939 or the Revenue Act of 1938 (52 Stat. 447), 1936 (49 Stat. 1652), 1934 (48 Stat. 683), 1932 (47 Stat. 169), or 1928 (45 Stat. 791), the basis of property after a consolidated return period shall be the same as the basis immediately prior to the close of such period.

§ 1.1052–1 Basis of property established by Revenue Act of 1932.

Section 1052(a) provides that if property was acquired after February 28, 1913, in any taxable year beginning before January 1, 1934, and the basis of the property, for the purposes of the Revenue Act of 1932 (47 Stat. 169), was prescribed by section 113(a) (6), (7), or (9) of that act, then for purposes of subtitle A of the Code, the basis shall be the same as the basis prescribed in the Revenue Act of 1932. For the rules applicable in determining the basis of stocks or securities under section 113(a)(9) of the Revenue Act of 1932 in case of certain distributions after December 31, 1923, and in any taxable year beginning before January 1, 1934, see 26 CFR (1939) 39.113 (a)(12)–1 (Regulations 118).

§ 1.1052–2 Basis of property established by Revenue Act of 1934.

Section 1052(b) provides that if property was acquired after February 28, 1913, in any taxable year beginning before January 1, 1936, and the basis of the property for the purposes of the Revenue Act of 1934 (48 Stat. 683) was prescribed by section 113(a) (6), (7), or (8) of that act, then for purposes of subtitle A of the Code, the basis shall be the same as the basis prescribed in the Revenue Act of 1934. For example, if after December 31, 1920, and in any taxable year beginning before January 1, 1936, property was acquired by a corporation by the issuance of its stock or securities in connection with a transaction which is not described in section 112(b)(5) of the Internal Revenue Code of 1939 but which is described in section 112(b)(5) of the Revenue Act of 1934, the basis of the property so acquired shall be the same as it would be in the hands of the transferor, with proper adjustments to the date of the exchange.

§ 1.1052–3 Basis of property established by the Internal Revenue Code of 1939.

Section 1052(c) provides that if property was acquired after February 28, 1913, in a transaction to which the Internal Revenue Code of 1939 applied and the basis thereof was prescribed by section 113(a) (6), (7), (8), (13), (15), (18), (19) or (23) of such Code, then for purposes of subtitle A of the Internal Revenue Code of 1954, the basis shall be the same as the basis prescribed in the Internal Revenue Code of 1939. In such cases, see section 113(a) of the Internal Revenue Code of 1939 and the regulations thereunder.

§ 1.1053–1 Property acquired before March 1, 1913.

(a) *Basis for determining gain.* In the case of property acquired before March 1, 1913, the basis as of March 1, 1913, for determining gain is the cost or other basis, adjusted as provided in section 1016 and other applicable provisions of chapter 1 of the Code, or its fair market value as of March 1, 1913, whichever is greater.

(b) *Basis for determining loss.* In the case of property acquired before March 1, 1913, the basis as of March 1, 1913, for determining loss is the basis determined in accordance with part II (section 1011 and following), subchapter O, chapter 1 of the Code, or other applicable provisions of chapter 1 of the Code, without reference to the fair market value as of March 1, 1913.

(c) *Example.* The application of paragraphs (a) and (b) of this section may be illustrated by the following example:

Example: (i) On March 1, 1908, a taxpayer purchased for $100,000, property having a useful life of 50 years. Assuming that there were no capital improvements to the property, the depreciation sustained on the property before March 1, 1913, was $10,000 (5 years @ $2,000), so that the original cost adjusted, as of March 1, 1913, for depreciation sustained prior to that date is $90,000. On that date the property had a fair market value of $94,500 with a remaining life of 45 years.

(ii) For the purpose of determining gain from the sale or other disposition of the property on March 1, 1954, the basis of the property is the fair market value of $94,500 as of March 1, 1913, adjusted for depreciation allowed or allowable after February 28, 1913, computed on $94,500. Thus, the substituted basis, $94,500, is reduced by the depreciation adjustment from March 1, 1913, to February 28, 1954, in the aggregate of $86,100 (41 years @ $2,100), leaving an adjusted basis for determining gain of $8,400 ($94,500 less $86,100).

(iii) For the purpose of determining loss from the sale or other disposition of such property on March 1, 1954, the basis of the property is its cost, adjusted for depreciation sustained before March 1, 1913, computed on cost, and the amount of depreciation allowed or allowable after February 28, 1913, computed on the fair market value of $94,500 as of March 1, 1913. In this example, the amount of depreciation sustained before March 1, 1913, is $10,000 and the amount of depreciation determined for the period after February 28, 1913, is $86,100. Therefore, the aggregate amount of depreciation for which the cost ($100,000) should be adjusted is $96,100 ($10,000 plus $86,100), and the adjusted basis for determining loss on March 1, 1954, is $3,900 ($100,000 less $96,100).

(d) *Fair market value.* The determination of the fair market value of property on March 1, 1913, is generally a question of fact and shall be established by competent evidence. In determining the fair market value of stock or other securities, due regard shall be given to the fair market value of the corporate assets as of such date, and other pertinent factors. In the case of property traded in on public exchanges, actual sales on or near the basic date afford evidence of value. In general, the fair market value of a block or aggregate of a particular kind of property is not to be determined by a forced-sale price, or by an estimate of what a whole block or aggregate would bring if placed upon the market at one and the same time. In such a case the value should be determined by ascertaining as the basis the fair market value of each unit of the property. All relevant facts and elements of value as of the basic date should be considered in each case.

§ 1.1054–1 Certain stock of Federal National Mortgage Association.

(a) *In general.* The basis in the hands of the initial holder of a share of stock which is issued pursuant to section 303(c) of the Federal National Mortgage Association Charter Act (12 U.S.C., section 1718) in a taxable year beginning after December 31, 1959, shall be an amount equal to the issuance price of the stock reduced by the amount, if any, required by section 162(d) to be treated (with respect to such share) as an ordinary and necessary business expense. See section 162(d) and § 1.162–19. For purposes of this section the initial holder is the original purchaser who is issued stock of the Federal National Mortgage Association (FNMA) pursuant to section 303(c) of the Act and who appears on the books of FNMA as the initial holder. See § 1.162–19.

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

Example: Pursuant to section 303(c) of the Federal National Mortgage Association Charter Act a certificate of FNMA stock is issued to A as of January 1, 1961. The

issuance price of the stock was $100 and the fair market value of the stock on the date of issue was $69. A was required by section 162(d) to treat $31 as a business expense for the year 1961. The basis of the share of stock in the hands of A, the initial holder, shall be $69, the amount paid for the stock ($100) reduced by $31.

[T.D. 6690, 28 FR 12254, Nov. 19, 1963]

§ 1.1055–1 General rule with respect to redeemable ground rents.

(a) *Character of a redeemable ground rent.* For purposes of subtitle A of the Code (1) a redeemable ground rent (as defined in section 1055(c) and paragraph (b) of this section) shall be treated as being in the nature of a mortgage, and (2) real property held subject to liabilities under such a redeemable ground rent shall be treated as held subject to liabilities under a mortgage. Thus, under section 1055(a) and this paragraph, the transfer of property subject to a redeemable ground rent has the same effect as the transfer of property subject to a mortgage, the acquisition of property subject to a redeemable ground rent is to be treated the same as the acquisition of property subject to a mortgage, and the holding of property subject to a redeemable ground rent is to be treated in the same manner as the holding of property subject to a mortgage. See section 163(c) for the treatment of any annual or periodic rental payment under a redeemable ground rent as interest.

(b) *Definition of redeemable ground rent.* For purposes of subtitle A of the Code, the term *redeemable ground rent* means only a ground rent with respect to which all the following conditions are met:

(1) There is a lease of land which is assignable by the lessee without the consent of the lessor.

(2) The term of the lease is for a period in excess of 15 years, taking into account all periods for which the lease may be renewed at the option of the lessee.

(3) The lessee has a present or future right to terminate the lease and to acquire the lessor's interest in the land (i.e., to redeem the ground rent) by the payment of a determined or determinable amount, which amount is referred to in §§ 1.1055–2, 1.1055–3, and 1.1055–4 as a *redemption price.* Such right must exist by virtue of State or local law. If the lessee's right to terminate the lease and to acquire the lessor's interest is not granted by State or local law but exists solely by virtue of a private agreement or privately created condition, the ground rent is not a *redeemable ground rent.*

(4) The lessor's interest in the land subject to the lease is primarily a security interest to protect the payment to him of the annual or periodic rental payments due under the lease.

(c) *Effective date.* In general, the provisions of section 1055 and paragraph (a) of this section take effect on April 11, 1963, and apply with respect to taxable years ending on or after such date. See § 1.1055–3 for rules for determining the basis of real property acquired subject to liabilities under a redeemable ground rent regardless of when such property was acquired. See also § 1.1055–4 for rules for determining the basis of a redeemable ground rent in the hands of a holder who reserved or created such ground rent in connection with a transfer, occurring before April 11, 1963, of the right to hold real property subject to liabilities under such ground rent.

[T.D. 6821, 30 FR 6216, May 4, 1965]

§ 1.1055–2 Determination of amount realized on the transfer of the right to hold real property subject to liabilities under a redeemable ground rent.

In determining the amount realized from a transfer, occurring on or after April 11, 1963, of the right to hold real property subject to liabilities under a redeemable ground rent, such ground rent shall be accounted for in the same manner as a mortgage for an amount of money equal to the redemption price of the ground rent. The provisions of this section apply in respect of any such transfer even though such ground rent was created prior to April 11, 1963. For provisions relating to the determination of the amount of and recognition of gain or loss from the sale or other disposition of property, see section 1001 and the regulations thereunder.

[T.D. 6821, 30 FR 6217, May 4, 1965]

§ 1.1055–3 Basis of real property held subject to liabilities under a redeemable ground rent.

(a) *In general.* The provisions of section 1055(a) and paragraph (a) of § 1.1055–1 are applicable in determining the basis of real property held on or after April 11, 1963, in any case where the property at the time of acquisition was subject to liabilities under a redeemable ground rent. (See section 1055(b)(2).) Thus, if on or after April 11, 1963, a taxpayer holds real property which was subject to liabilities under a redeemable ground rent at the time he acquired it, the basis of such property in the hands of such taxpayer, regardless of when the property was acquired, will include the redeemable ground rent in the same manner as if it were a mortgage in an amount equal to the redemption price of such ground rent. Likewise, if on or after April 11, 1963, a taxpayer holds real property which was subject to liabilities under a redeemable ground rent at the time he acquired it and which has a substituted basis in his hands, the basis of the property in the hands of the taxpayer's predecessor in interest is to be determined by treating the redeemable ground rent in the same manner as a mortgage in an amount equal to the redemption price of such ground rent.

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

Example 1. On April 11, 1963, taxpayer A held residential property which he acquired on January 15, 1963, for a purchase price of $10,000 and which, at the time he acquired it, was subject to a ground rent redeemable for a redemption price of $1,600. A's basis for the property includes the purchase price ($10,000) plus the redeemable ground rent in the same manner as if it were a mortgage for $1,600.

Example 2. In 1962, taxpayer X, a corporation, acquired real property subject to a redeemable ground rent in a transfer to which section 351 (relating to transfer of property to corporation controlled by transferor) applied and in which the basis of the property to X was the transferor's basis. X still held the property on April 11, 1963. The transferor's basis in the property is to be determined by treating the redeemable ground rent to which it was subject in the transferor's hands as if it were a mortgage.

[T.D. 6821, 30 FR 6217, May 4, 1965]

§ 1.1055–4 Basis of redeemable ground rent reserved or created in connection with transfers of real property before April 11, 1963.

(a) *In general.* In the case of a redeemable ground rent created or reserved in connection with a transfer, occurring before April 11, 1963, of the right to hold real property subject to liabilities under such ground rent, the basis of such ground rent on or after April 11, 1963, in the hands of the person who reserved or created the ground rent is the amount which was taken into account in respect of such ground rent in computing the amount realized from the transfer of such real property. Thus, if no such amount was taken into account, such basis shall be determined without regard to section 1055. (See section 1055(b)(3).)

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

Example 1. The taxpayer, who was in the business of building houses, purchased an undeveloped lot of land for $500 and built a house thereon at a cost of $10,000. Subsequently, he transferred the right to hold the lot improved by the house for a consideration of $12,000, and an annual ground rent for such property of $120 which was redeemable for a redemption price of $2,000. The taxpayer reported a $2,000 gain on the transfer, treating the amount realized as $12,000 and his cost allocable to the interest transferred as $10,000. Since the builder did not take the redeemable ground rent into account in computing gain on the transfer, his basis for such ground rent is $500 (the cost of the land not offset against the consideration received for the transfer). Thus, if he subsequently sells the redeemable ground rent (or if it is redeemed from him) for $2,000, he has no gain of $1,500 in the year of sale (or redemption).

Example 2. Assume the same facts as in Example 1 except that the builder reported a gain of $3,500 on the transfer, treating the amount realized as $14,000 ($12,000 cash plus $2,000 for the redeemable ground rent) and his costs as $10,500 ($10,000 for the house and $500 for the lot). Since the taxpayer took the entire amount of the redeemable ground rent into account in computing his gain, his basis for such ground rent is $2,000. Thus, if he subsequently sells the redeemable ground rent (or if it is redeemed from him) for $2,000, he has no gain or loss on the transaction.

Example 3. Assume the same facts as in Example 1 except that the builder reported a gain of $3,000 on the transfer. He computed this gain by treating the amount realized as $12,000 but treating his cost allocable to the

interest transferred as $12,000/$14,000ths of his total $10,500 cost, or $9,000. Since the builder still has remaining $1,500 of unallocated cost, his basis for the redeemable ground rent is $1,500. Thus, if he subsequently sells the redeemable ground rent (or if it is redeemed from him) for $2,000, he has a gain of $500 in the year of sale (or redemption).

[T.D. 6821, 30 FR 6217, May 4, 1965]

§ 1.1059(e)–1 Non-pro rata redemptions.

(a) *In general*. Section 1059(d)(6) (exception where stock held during entire existence of corporation) and section 1059(e)(2) (qualifying dividends) do not apply to any distribution treated as an extraordinary dividend under section 1059(e)(1). For example, if a redemption of stock is not pro rata as to all shareholders, any amount treated as a dividend under section 301 is treated as an extraordinary dividend regardless of whether the dividend is a qualifying dividend.

(b) *Reorganizations*. For purposes of section 1059(e)(1), any exchange under section 356 is treated as a redemption and, to the extent any amount is treated as a dividend under section 356(a)(2), it is treated as a dividend under section 301.

(c) *Effective date*. This section applies to distributions announced (within the meaning of section 1059(d)(5)) on or after June 17, 1996.

[T.D. 8724, 62 FR 38028, July 16, 1997]

§ 1.1059A–1 Limitation on taxpayer's basis or inventory cost in property imported from related persons.

(a) *General rule*. In the case of property imported into the United States in a transaction (directly or indirectly) by a controlled taxpayer from another member of a controlled group of taxpayers, except for the adjustments permitted by paragraph (c) (2) of this section, the amount of any costs taken into account in computing the basis or inventory cost of the property by the purchasing U.S. taxpayer and which costs are also taken into account in computing the valuation of the property for customs purposes may not, for purposes of the basis or inventory cost, be greater than the amount of the costs used in computing the customs value. For purposes of this section, the terms *controlled taxpayer* and *group of controlled taxpayers* shall have the meaning set forth in § 1.482–1(a).

(b) *Definitions*—(1) *Import*. For purposes of section 1059A and this section only, the term *import* means the filing of the entry documentation required by the U.S. Customs Service to secure the release of imported merchandise from custody of the U.S. Customs Service.

(2) *Indirectly*. For purposes of this section, *indirectly* refers to a transaction between a controlled taxpayer and another member of the controlled group whereby property is imported through a person acting as an agent of, or otherwise on behalf of, either or both related persons, or as a middleman or conduit for transfer of the property between a controlled taxpayer and another member of the controlled group. In the case of the importation of property indirectly, an adjustment shall be permitted under paragraph (c)(2) of this section for a commission or markup paid to the person acting as agent, middleman, or conduit, only to the extent that the commission or markup: is otherwise properly included in cost basis or inventory cost; was actually incurred by the taxpayer and not remitted, directly or indirectly, to the taxpayer or related party; and there is a substantial business reason for the use of a middleman, agent, or conduit.

(c) *Customs value*—(1) *Definition*. For purposes of this section only, the term *customs value* means the value required to be taken into account for purposes of determining the amount of any customs duties or any other duties which may be imposed on the importation of any property. Where an item or a portion of an item is not subject to any customs duty or is subject to a free rate of duty, such item or portion of such item shall not be subject to the provisions of section 1059A or this section. Thus, for example, the portion of an item that is an American good returned and not subject to duty (items 806.20 and 806.30, Tariff Schedules of the United States, 19 U.S.C. 1202); imports on which no duty is imposed that are valued by customs for statistical purposes only; and items subject to a zero rate of duty (19 U.S.C. 1202, General Headnote 3) are not subject to section

1059A or this section. Also, items subject only to the user fee under 19 U.S.C. 58(c), or the harbor maintenance tax imposed by 26 U.S.C. 4461, or only to both, are not subject to section 1059A or this section. This section imposes no limitation on a claimed basis or inventory cost in property which is less than the value used to compute the customs duty with respect to the same property. Section 1059A and this section have no application to imported property not subject to any customs duty based on value, including property subject only to a per item duty or a duty based on volume, because there is no customs value, within the meaning of this paragraph, with respect to such property.

(2) *Adjustments to customs value.* To the extent not otherwise included in customs value, a taxpayer, for purposes of determining the limitation on claimed basis or inventory cost of property under this section, may increase the customs value of imported property by the amounts incurred by it and properly included in inventory cost for—

(i) Freight charges,

(ii) Insurance charges,

(iii) The construction, erection, assembly, or technical assistance provided with respect to, the property after its importation into the United States, and

(iv) Any other amounts which are not taken into account in determining the customs value, which are not properly includible in customs value, and which are appropriately included in the cost basis or inventory cost for income tax purposes. See §1.471–11 and section 263A.

Appropriate adjustments may also be made to customs values when the taxpayer has not allocated the value of assists to individual articles but rather has reported the value of assists on a periodic basis in accordance with 19 CFR 152.103(e). When 19 CFR 152.103(e) has been utilized for customs purposes, the taxpayer may adjust his customs values by allocating the value of the assists to all imported articles to which the assists relate. To the extent that an amount attributable to an adjustment permitted by this section is paid by a controlled taxpayer to another member of the group of controlled taxpayers, an adjustment is permitted under this section only to the extent that the amount incurred represents an arm's length charge within the meaning of §1.482–1(d)(3).

(3) *Offsets to adjustments.* To the extent that a customs value is adjusted under paragraph (c)(2) of this section for purposes of calculating the limitation on claimed cost basis or inventory cost under this section, the amount of the adjustments must be offset (reduced) by amounts that properly reduce the cost basis of inventory and that are not taken into account in determining customs value, such as rebates and other reductions in the price actually incurred, effected between the purchaser and related seller after the date of importation of the property.

(4) *Application of section 1059A to property having dutiable and nondutiable portions.* When an item of imported property is subiect to a duty upon the full value of the imported article, less the cost or value of American goods returned, and the taxpayer claims a basis or inventory cost greater than the customs value reported for the item, the claimed tax basis or inventory cost in the dutiable portion of the item is limited under section 1059A and this section to the customs value of the dutiable portion under paragraph (c)(1). The claimed tax basis or inventory cost in the nondutiable portion of the item is determined by multiplying the customs value of the nondutiable portion by a fraction the numerator of which is the amount by which the claimed basis or inventory cost of the item exceeds the customs value of the item and the denominator of which is the customs value of the item and adding this amount to the customs value of the nondutiable portion of the item. The claimed tax basis or inventory cost in the dutiable portion is determined by multiplying the customs value of the dutiable portion by a fraction the numerator of which is the amount by which the claimed basis or inventory cost of the item exceeds the customs value of the item and the denominator of which is the customs value of the item and adding this amount to the customs value of the dutiable portion of the item. However, the taxpayer

may not claim a tax basis or inventory cost in the dutiable portion greater than the customs value of this portion of the item.

(5) *Allocation of adjustments to property having dutiable and nondutiable portions.* When an item of imported property is subject to a duty upon the full value of the imported article, less the cost or value of American goods returned, and the taxpayer establishes that the customs value may be increased by adjustments permitted under paragraph (c)(2) of this section for purposes of the section 1059A limitation, the taxpayer's basis or inventory cost of the dutiable portion of the item is determined by multiplying the customs value of the dutiable portion times the percentage that the adjustments represent of the total customs value of the item and adding this amount to the customs value of the dutiable portion of the item. The taxpayer's basis or inventory cost of the nondutiable portion of the item is determined in the same manner. The amount so determined for the dutiable portion of the item is the section 1059A limitation for this portion of the item.

(6) *Alternative method of demonstrating compliance.* In lieu of calculating all adjustments and offsets to adjustments to customs value for an item of property pursuant to paragraph (c) (2) and (3) of this section, a taxpayer may demonstrate compliance with this section and section 1059A by comparing costs taken into account in computing basis or inventory costs of the property and the costs taken into account in computing customs value at any time after importation, provided that in any such comparison the same costs are included both in basis or inventory costs and in customs value. If, on the basis of such comparison, the basis or inventory cost is equal to or less than the customs value, the taxpayer shall be deemed to have met the requirements of this section and section 1059A.

(7) *Relationship of section 1059A to section 482.* Neither this section nor section 1059A limits in any way the authority of the Commissioner to increase or decrease the claimed basis or inventory cost under section 482 or any other appropriate provision of law. Neither does this section or section 1059A permit a taxpayer to adjust upward its cost basis or inventory cost for property appropriately determined under section 482 because such basis or inventory cost is less than the customs value with respect to such property.

(8) *Illustrations.* The application of this section may be illustrated by the following examples:

Example 1. Corporation X, a United States taxpayer, and Y Corporation are members of a group of controlled corporations. X pays $2,000 to Y for merchandise imported into the United States and an additional $150 for ocean freight and insurance. The customs value of the shipment is determined to be the amount actually paid by X ($2,000) and does not include the charges for ocean freight and insurance. For purposes of computing the limitation on its inventory cost for the merchandise under section 1059A and this section, X is permitted, under paragraph (c)(2) of this section, to increase the customs value ($2,000) by amounts it paid for ocean freight and insurance charges ($150). Thus, the inventory cost claimed by X in the merchandise may not exceed $2,150.

Example 2. Assume the same facts as in Example 1 except that, subsequent to the date of importation of the merchandise, Y grants to X a rebate of $200 of the purchase price. At the time of sale, the rebate was contingent upon the volume of merchandise ultimately bought by X from Y. The value of the merchandise, for customs purposes, is not decreased by the rebate paid to X by Y. Therefore, the customs value, for customs purposes, of the merchandise remains the same ($2,000). For purposes of computing its inventory cost, X was permitted, under paragraph (c)(2) of this section, to increase the customs value for purposes of section 1059A of $2,000 by the amounts it paid for ocean freight and insurance charges ($150). However, under paragraph (c)(3) of this section, X is required to reduce the amount of the customs value by the lesser of the amount of the rebate or the amount of any positive adjustments to the original customs value. The inventory price claimed by X may not exceed $2,000 ($2,000 customs value, plus $150 transportation adjustment, less $150 offsetting rebate adjustment). While X's limitation under section 1059A is $2,000, X may not claim a basis or inventory cost in the merchandise in excess of $1,950. *See* I.R.C. section 1012; and section 1.471–2.

Example 3. Corporation X, a United States taxpayer, and Y Corporation are members of a group of controlled corporations. X pays $10,000 to Y for merchandise imported into the United States. The merchandise is composed, in part, of American goods returned. The customs value of the merchandise, on

which a customs duty is imposed, is determined to be $8,000 ($10,000, the amount declared by X, less $2,000, the value of the American goods returned). For income tax purposes, X claims a cost basis in the merchandise of $11,000. None of the adjustments permitted by paragraph (c)(2) of this section is applicable. The portion of the merchandise constituting American goods returned represented 20 percent of the total customs value of the merchandise. Since the cost basis claimed by X for income tax purposes represents a 10 percent increase over the customs valuation (before reduction for American goods returned), the claimed tax basis in the dutiable content is considered to be $8,800 and in the portion constituting American goods returned is $2,200. Since a customs duty was imposed only on the dutiable content of the merchandise, the limitation in section 1059A and this section is applicable only to the claimed tax basis in this portion of the merchandise. Accordingly, under paragraph (a) of this section, X is limited to a cost basis of $10,200 in the merchandise. This amount represents a cost basis of $8,000 in the dutiable content and of $2,200 in the portion of the merchandise constituting American goods returned.

Example 4. Assume the same facts as in Example 3 except that X establishes that it is entitled to increase its customs value by $1,000 in adjustments permitted by paragraph (c)(2) of this section. Since the adjustments to customs value that X is entitled to under paragraph (c)(2) of this section are 10 percent of the customs value, for purposes of determining the limitation under section 1059A and this section, both the dutiable content and the portion of the merchandise constituting American goods returned shall be increased to an amount 10 percent greater than the respective values determined for customs purposes, or $8,800 for the dutiable content and $2,200 for the portion of the merchandise constituting American goods returned. Accordingly, under paragraph (a) of this section, X is limited to a cost basis of $11,000 in the merchandise.

Example 5. Corporation X, a United States taxpayer, and Y Corporation are members of a group of controlled corporations. X pays $10,000 to Y for merchandise imported into the United States. The customs value of the merchandise, on which a customs duty is imposed, is determined to be $10,000. Subsequent to the date of importation of the merchandise, Y grants to X a rebate of $1,000 of the purchase price. The value of the merchandise, for customs purposes, is not decreased by the rebate paid to X by Y. Notwithstanding the fact that X correctly reported and paid customs duty on a value of $10,000 and that its limitation on basis or inventory cost under this section is $10,000, X may not claim a basis or inventory cost in the merchandise in excess of $9,000. *See* I.R.C. section 1012; and section 1.471–2.

Example 6. Corporation X, a United States taxpayer, and Y Corporation are members of a group of controlled corporations. X pays $5,000 to Y for merchandise imported into the United States. The merchandise is not subject to a customs duty or is subject to a free rate of duty and is valued by customs solely for statistical purposes. Accordingly, pursuant to paragraph (c)(1) of this section, the merchandise is not subject to the provisions of section 1059A or this section.

Example 7. Assume the same facts as in Example 6, except that the merchandise is subject to a customs duty based on value and that the customs value (taking into account no costs other than the value of the goods) is determined to be $5,000. Assume further that the $5,000 payment is only for the value of the goods, no other cost is reflected in that payment, and only the $5,000 payment to Y is reflected in X's inventory cost or basis prior to inclusion of any other amounts properly included in inventory or cost basis. Pursuant to paragraph (c)(6) of this section, X, by demonstrating these facts is deemed to meet the requirements of this section and section 1059A.

Example 8. Corporation X, a United States taxpayer, and Y Corporation are members of a group of controlled corporations. X pays $9 to Y for merchandise imported into the United States and an additional $1 for ocean freight. The customs value of the article does not include the $1 paid for ocean freight. Furthermore, for customs purposes the value is calculated pursuant to computed value and is determined to be $8. For purposes of computing the limitation on its inventory cost for the article under section 1059A and this section, X is permitted, under paragraph (c)(2) of this section, to increase the customs value ($8) by the amount it paid for ocean freight ($1). Thus, the inventory cost claimed by X in the article may not exceed $9.

(9) *Averaged customs values.* In cases of transactions in which (i) an appropriate transfer price is properly determined for tax purposes by reference to events occurring after importation, (ii) the value for customs purposes of one article is higher and of a second article is lower than the actual transaction values, (iii) the relevant articles have been appraised on the basis of a value estimated at the time of importation in accordance with customs regulations, and (iv) the entries have been liquidated upon importation, the section 1059A limitation on the undervalued article may be increased up to the amount of actual transaction value by the amount of the duty overpaid on

the overvalued article times a fraction the numerator of which is ''1'' and the denominator of which is the rate of duty on the undervalued article. This paragraph (c)(9) applies exclusively to cases of property imported in transactions that are open for tax purposes in which the actual transaction value cannot be determined and the entry has been liquidated for customs purposes on the basis of a value estimated at the time of importation in accordance with customs regulations; in these cases, the property is appropriately valued for tax purposes by reference to a formula, in existence at the time of importation, based on subsequent events and valued for customs purposes by a different formula. This paragraph (c)(9) does not apply where customs value is correctly determined for purposes of liquidating the entry and where the customs value is subsequently adjusted for tax purposes, for example by a rebate, under paragraph (c)(2) of this section. The application of paragraph (c)(9) may be illustrated by the following example:

Example: Corporation X, a United States taxpayer, and Y Corporation are members of a group of controlled corporations. X purchases Articles A and B from Y on consignment and imports the Articles into the United States. The purchase price paid by X will be determined as a percentage of the sale prices that X realizes. Rather than deferring liquidation, customs liquidates the entry on the basis of estimated values and the customs duties are paid by X. Ultimately, it is determined that Article A was undervalued and Article B was overvalued by X for customs purposes. The section 1059A limitation for Article A is computed as follows:

	Article A	Article B
Finally-determined customs value	$9	$9
Transaction value	$10	$5
Duty rate	10%	5%
Customs duty paid	$.90	$.45
Duty overpaid or (underpaid)	($.10)	$.20

The section 1059A limitation on Article A may be increased by the amount of the duty over-paid on Article B, $.20, times 1/.10, up to the amount of the transaction value. Therefore, the section 1059A limitation on Article A is $9.00 plus $1.00, or a total of $10.00. The section 1059A limitation on Article B is reduced (but never below transaction value) by $2.00 to $7.00.

(d) *Finality of customs value and of other determinations of the U.S. Customs Service.* For purposes of section 1059A and this section, a taxpayer is bound by the finally-determined customs value and by every final determination made by the U.S. Customs Service, including, but not limited to, dutiable value, the value attributable to the cost or value of products of the United States, and classification of the product for purposes of imposing any duty. The customs value is considered to be finally determined, and all U.S. Customs Service determinations are considered final, when liquidation of the entry becomes final. For this purpose, the term *liquidation* means the ascertainment of the customs duties occurring on the entry of the property, and liquidation of the entry is considered to become final after 90 days following notice of liquidation to the importer, unless a protest is filed. If the importer files a protest, the customs value will be considered finally determined and all other U.S. Customs Service determinations will be considered final either when a decision by the Customs Service on the protest is not contested after expiration of the period allowed to contest the decision or when a judgment of the Court of International Trade becomes final. For purposes of this section, any adjustments to the customs value resulting from a petition under 19 U.S.C. section 1516 (requests by interested parties unrelated to the importer for redetermination of the appraised value, classification, or the rate of duty imposed on imported merchandise) or reliquidation under 19 U.S.C. section 1521 (reliquidation by the Customs Service upon a finding that fraud was involved in the original liquidation) will not be taken into account. However, reliquidation under 19 U.S.C. section 1501 (voluntary reliquidation by the Customs Service within 90 days of the original liquidation to correct errors in appraisement, classification, or any element entering into a liquidation or reliquidation) or reliquidation under 19 U.S.C. section 1520(c)(1) (to correct a clerical error, mistake of fact, or other inadvertance within one year of a liquidation or reliquidation) will be taken into account in the same manner as, and take the

place of, the original liquidation in determining customs value.

(e) *Drawbacks*. For purposes of this section, a drawback, that is, a refund or remission (in whole or in part) of a customs duty because of a particular use made (or to be made) of the property on which the duty was assessed or collected, shall not affect the determination of the customs value of the property.

(f) *Effective date*. Property imported by a taxpayer is subject to section 1059A and this section if the entry documentation required to be filed to obtain the release of the property from the custody of the United States Customs Service was filed after March 18, 1986. Section 1059A and this section will not apply to imported property where (1) the entry documentation is filed prior to September 3, 1987; and (2) the importation was liquidated under the circumstances described in paragraph (c)(9) of this section.

[T.D. 8260, 54 FR 37311, Sept. 8, 1989]

§ 1.1060–1 Special allocation rules for certain asset acquisitions.

(a) *Scope*—(1) *In general*. This section prescribes rules relating to the requirements of section 1060, which, in the case of an applicable asset acquisition, requires the transferor (the seller) and the transferee (the purchaser) each to allocate the consideration paid or received in the transaction among the assets transferred in the same manner as amounts are allocated under section 338(b)(5) (relating to the allocation of adjusted grossed-up basis among the assets of the target corporation when a section 338 election is made). In the case of an applicable asset acquisition described in paragraph (b)(1) of this section, sellers and purchasers must allocate the consideration under the residual method as described in §§ 1.338–6 and 1.338–7 in order to determine, respectively, the amount realized from, and the basis in, each of the transferred assets. For rules relating to distributions of partnership property or transfers of partnership interests which are subject to section 1060(d), see § 1.755–2T.

(2) *Effective dates*—(i) *In general*. The provisions of this section apply to any asset acquisition occurring after March 15, 2001. However, paragraphs (b)(9) and (c)(5) of this section apply only to applicable asset acquisitions occurring on or after April 10, 2006. A purchaser or a seller may make an irrevocable election to apply the rules in §§ 1.338–11 (including the applicable provisions in §§ 1.197–2(g)(5), 1.381(c)(22)–1, 846 and 1060) to an applicable asset acquisition occurring before April 10, 2006. Paragraph (a)(2)(ii) of this section describes the time and manner of the election for the purchaser and paragraph (a)(2)(iii) of this section prescribes the time and manner of the election for the seller. The seller may make the election to apply the regulations retroactively without regard to whether the purchaser also makes the election. For rules applicable to asset acquisitions on or before March 15, 2001, *see* § 1.1060–1T in effect before March 16, 2001 (*see* 26 CFR part 1 revised April 1, 2000).

(ii) *Time and manner of making the election for the purchaser*. The purchaser may make an election described in this paragraph (a)(2) by attaching a statement to its original or amended income tax return for the taxable year that includes the applicable asset sale. The statement must be entitled ''Election to Retroactively Apply the Rules in § 1.338–11 (Including the Applicable Provisions in §§ 1.197–2(g)(5), 1.381(c)(22)–1, 846 and 1060) to an Applicable Asset Acquisition Completed Before April 10, 2006'' and must include the following information—

(A) The name and E.I.N. for the purchaser; and

(B) The following declaration (or a substantially similar declaration): The purchaser has amended its income tax returns for the taxable year that includes the applicable asset acquisition and for all affected subsequent years to reflect the rules in § 1.338–11 (Including the Applicable Provisions in §§ 1.197–2(g)(5), 1.381(c)(22)–1,846 and 1060).

(iii) *Time and manner of making the election for the seller*. The seller may make an election described in this paragraph (a)(2) by attaching a statement to its original or amended income tax return for the taxable year that includes the applicable asset sale. The statement must be entitled ''Election to retroactively apply the rules in

§ 1.338–11 (including the applicable provisions in §§ 1.197–2(g)(5), 1.381(c)(22)–1, 846 and 1060) to an applicable asset acquisition completed before April 10, 2006'' and must include the following information—

(A) The name and E.I.N. for the seller; and

(B) The following declaration (or a substantially similar declaration): The seller has amended its income tax returns for the taxable year that includes the applicable asset acquisition and for all affected subsequent years to reflect the rules in § 1.338–11 (including the applicable provisions in §§ 1.197–2(g)(5), 1.381(c)(22)–1, 846 and 1060).

(3) *Outline of topics*. In order to facilitate the use of this section, this paragraph (a)(3) lists the major paragraphs in this section as follows:

(a) Scope.
(1) In general.
(2) Effective date.
(3) Outline of topics.
(b) Applicable asset acquisition.
(1) In general.
(2) Assets constituting a trade or business.
(i) In general.
(ii) Goodwill or going concern value.
(iii) Factors indicating goodwill or going concern value.
(3) Examples.
(4) Asymmetrical transfers of assets.
(5) Related transactions.
(6) More than a single trade or business.
(7) Covenant entered into by the seller.
(8) Partial non-recognition exchanges.
(9) Insurance business.
(c) Allocation of consideration among assets under the residual method.
(1) Consideration.
(2) Allocation of consideration among assets.
(3) Certain costs.
(4) Effect of agreement between parties.
(5) Insurance business.
(d) Examples.
(e) Reporting requirements.
(1) Applicable asset acquisitions.
(i) In general.
(ii) Time and manner of reporting.
(A) In general.
(B) Additional reporting requirement.
(C) Election described in § 1.338–6(c)(5).
(2) Transfers of interests in partnerships.

(b) *Applicable asset acquisition*—(1) *In general*. An applicable asset acquisition is any transfer, whether direct or indirect, of a group of assets if the assets transferred constitute a trade or business in the hands of either the seller or the purchaser and, except as provided in paragraph (b)(8) of this section, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration.

(2) *Assets constituting a trade or business*—(i) *In general*. For purposes of this section, a group of assets constitutes a trade or business if—

(A) The use of such assets would constitute an active trade or business under section 355; or

(B) Its character is such that goodwill or going concern value could under any circumstances attach to such group.

(ii) *Goodwill or going concern value*. Goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor. Going concern value is the additional value that attaches to property because of its existence as an integral part of an ongoing business activity. Going concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership. It also includes the value that is attributable to the immediate use or availability of an acquired trade or business, such as, for example, the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.

(iii) *Factors indicating goodwill or going concern value*. In making the determination in this paragraph (b)(2), all the facts and circumstances surrounding the transaction are taken into account. Whether sufficient consideration is available to allocate to goodwill or going concern value after the residual method is applied is not relevant in determining whether goodwill or going concern value could attach to a group of assets. Factors to be considered include—

(A) The presence of any intangible assets (whether or not those assets are section 197 intangibles), provided, however, that the transfer of such an asset in the absence of other assets will not

be a trade or business for purposes of section 1060;

(B) The existence of an excess of the total consideration over the aggregate book value of the tangible and intangible assets purchased (other than goodwill and going concern value) as shown in the financial accounting books and records of the purchaser; and

(C) Related transactions, including lease agreements, licenses, or other similar agreements between the purchaser and seller (or managers, directors, owners, or employees of the seller) in connection with the transfer.

(3) *Examples*. The following examples illustrate paragraphs (b)(1) and (2) of this section:

Example 1. S is a high grade machine shop that manufactures microwave connectors in limited quantities. It is a successful company with a reputation within the industry and among its customers for manufacturing unique, high quality products. Its tangible assets consist primarily of ordinary machinery for working metal and plating. It has no secret formulas or patented drawings of value. P is a company that designs, manufactures, and markets electronic components. It wants to establish an immediate presence in the microwave industry, an area in which it previously has not been engaged. P is acquiring assets of a number of smaller companies and hopes that these assets will collectively allow it to offer a broad product mix. P acquires the assets of S in order to augment its product mix and to promote its presence in the microwave industry. P will not use the assets acquired from S to manufacture microwave connectors. The assets transferred are assets that constitute a trade or business in the hands of the seller. Thus, P's purchase of S's assets is an applicable asset acquisition. The fact that P will not use the assets acquired from S to continue the business of S does not affect this conclusion.

Example 2. S, a sole proprietor who operates a car wash, both leases the building housing the car wash and sells all of the car wash equipment to P. S's use of the building and the car wash equipment constitute a trade or business. P begins operating a car wash in the building it leases from S. Because the assets transferred together with the asset leased are assets which constitute a trade or business, P's purchase of S's assets is an applicable asset acquisition.

Example 3. S, a corporation, owns a retail store business in State X and conducts activities in connection with that business enterprise that meet the active trade or business requirement of section 355. P is a minority shareholder of S. S distributes to P all the assets of S used in S's retail business in State X in complete redemption of P's stock in S held by P. The distribution of S's assets in redemption of P's stock is treated as a sale or exchange under sections 302(a) and 302(b)(3), and P's basis in the assets distributed to it is determined wholly by reference to the consideration paid, the S stock. Thus, S's distribution of assets constituting a trade or business to P is an applicable asset acquisition.

Example 4. S is a manufacturing company with an internal financial bookkeeping department. P is in the business of providing a financial bookkeeping service on a contract basis. As part of an agreement for P to begin providing financial bookkeeping services to S, P agrees to buy all of the assets associated with S's internal bookkeeping operations and provide employment to any of S's bookkeeping department employees who choose to accept a position with P. In addition to selling P the assets associated with its bookkeeping operation, S will enter into a long term contract with P for bookkeeping services. Because assets transferred from S to P, along with the related contract for bookkeeping services, are a trade or business in the hands of P, the sale of the bookkeeping assets from S to P is an applicable asset acquisition.

(4) *Asymmetrical transfers of assets*. A purchaser is subject to section 1060 if—

(i) Under general principles of tax law, the seller is not treated as transferring the same assets as the purchaser is treated as acquiring;

(ii) The assets acquired by the purchaser constitute a trade or business; and

(iii) Except as provided in paragraph (b)(8) of this section, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration.

(5) *Related transactions*. Whether the assets transferred constitute a trade or business is determined by aggregating all transfers from the seller to the purchaser in a series of related transactions. Except as provided in paragraph (b)(8) of this section, all assets transferred from the seller to the purchaser in a series of related transactions are included in the group of assets among which the consideration paid or received in such series is allocated under the residual method. The principles of § 1.338–1(c) are also applied in determining which assets are included in the group of assets among

which the consideration paid or received is allocated under the residual method.

(6) *More than a single trade or business.* If the assets transferred from a seller to a purchaser include more than one trade or business, then, in applying this section, all of the assets transferred (whether or not transferred in one transaction or a series of related transactions and whether or not part of a trade or business) are treated as a single trade or business.

(7) *Covenant entered into by the seller.* If, in connection with an applicable asset acquisition, the seller enters into a covenant (e.g., a covenant not to compete) with the purchaser, that covenant is treated as an asset transferred as part of a trade or business.

(8) *Partial non-recognition exchanges.* A transfer may constitute an applicable asset acquisition notwithstanding the fact that no gain or loss is recognized with respect to a portion of the group of assets transferred. All of the assets transferred, including the non-recognition assets, are taken into account in determining whether the group of assets constitutes a trade or business. The allocation of consideration under paragraph (c) of this section is done without taking into account either the non-recognition assets or the amount of money or other property that is treated as transferred in exchange for the non-recognition assets (together, the non-recognition exchange property). The basis in and gain or loss recognized with respect to the non-recognition exchange property are determined under such rules as would otherwise apply to an exchange of such property. The amount of the money and other property treated as exchanged for non-recognition assets is the amount by which the fair market value of the non-recognition assets transferred by one party exceeds the fair market value of the non-recognition assets transferred by the other (to the extent of the money and the fair market value of property transferred in the exchange). The money and other property that are treated as transferred in exchange for the non-recognition assets (and which are not included among the assets to which section 1060 applies) are considered to come from the following assets in the following order: first from Class I assets, then from Class II assets, then from Class III assets, then from Class IV assets, then from Class V assets, then from Class VI assets, and then from Class VII assets. For this purpose, liabilities assumed (or to which a non-recognition exchange property is subject) are treated as Class I assets. See *Example 1* in paragraph (d) of this section for an example of the application of section 1060 to a single transaction which is, in part, a non-recognition exchange.

(9) *Insurance business.* The mere reinsurance of insurance contracts by an insurance company is not an applicable asset acquisition, even if it enables the reinsurer to establish a customer relationship with the owners of the reinsured contracts. However, a transfer of an insurance business is an applicable asset acquisition if the purchaser acquires significant business assets, in addition to insurance contracts, to which goodwill and going concern value could attach. For rules regarding the treatment of an applicable asset acquisition of an insurance business, see paragraph (c)(5) of this section.

(c) *Allocation of consideration among assets under the residual method*—(1) *Consideration.* The seller's consideration is the amount, in the aggregate, realized from selling the assets in the applicable asset acquisition under section 1001(b). The purchaser's consideration is the amount, in the aggregate, of its cost of purchasing the assets in the applicable asset acquisition that is properly taken into account in basis.

(2) *Allocation of consideration among assets.* For purposes of determining the seller's amount realized for each of the assets sold in an applicable asset acquisition, the seller allocates consideration to all the assets sold by using the residual method under §§ 1.338–6 and 1.338–7, substituting consideration for ADSP. For purposes of determining the purchaser's basis in each of the assets purchased in an applicable asset acquisition, the purchaser allocates consideration to all the assets purchased by using the residual method under §§ 1.338–6 and 1.338–7, substituting consideration for AGUB. In allocating consideration, the rules set forth in paragraphs (c)(3) and (4) of this section

apply in addition to the rules in §§ 1.338–6 and 1.338–7.

(3) *Certain costs*. The seller and purchaser each adjusts the amount allocated to an individual asset to take into account the specific identifiable costs incurred in transferring that asset in connection with the applicable asset acquisition (e.g., real estate transfer costs or security interest perfection costs). Costs so allocated increase, or decrease, as appropriate, the total consideration that is allocated under the residual method. No adjustment is made to the amount allocated to an individual asset for general costs associated with the applicable asset acquisition as a whole or with groups of assets included therein (e.g., non-specific appraisal fees or accounting fees). These latter amounts are taken into account only indirectly through their effect on the total consideration to be allocated. If an election described in § 1.338–6(c)(5) is made with respect to an applicable asset acquisition, any allocation of costs pursuant to this paragraph (c)(3) shall be made as if such election had not been made. The preceding sentence applies to applicable asset acquisitions occurring on or after September 11, 2007. For applicable asset acquisitions occurring before September 11, 2007, and on or after September 15, 2004, see § 1.1060–1T as contained in 26 CFR Part 1 in effect on April 1, 2007. For applicable asset acquisitions occurring before September 15, 2004, see §§ 1.338–6 and 1.1060–1 as contained in 26 CFR Part 1 in effect on April 1, 2004.

(4) *Effect of agreement between parties*. If, in connection with an applicable asset acquisition, the seller and purchaser agree in writing as to the allocation of any amount of consideration to, or as to the fair market value of, any of the assets, such agreement is binding on them to the extent provided in this paragraph (c)(4). Nothing in this paragraph (c)(4) restricts the Commissioner's authority to challenge the allocations or values arrived at in an allocation agreement. This paragraph (c)(4) does not apply if the parties are able to refute the allocation or valuation under the standards set forth in *Commissioner* v. *Danielson*, 378 F.2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967) (a party wishing to challenge the tax consequences of an agreement as construed by the Commissioner must offer proof that, in an action between the parties to the agreement, would be admissible to alter that construction or show its unenforceability because of mistake, undue influence, fraud, duress, etc.).

(5) *Insurance business*. If the trade or business transferred is an insurance business, the rules of this paragraph (c) are modified by the principles of § 1.338–11(a) through (d). However, in transactions governed by section 1060, such principles apply even if the transfer of the trade or business is effected in whole or in part through indemnity reinsurance rather than assumption reinsurance, and, for the insurer or reinsurer, an insurance contract (including an annuity or reinsurance contract) is a Class VI asset regardless of whether it is a section 197 intangible. In addition, the principles of § 1.338–11(f) through (h) apply if the transfer occurs in connection with the complete liquidation of the transferor.

(d) *Examples*. The following examples illustrate this section:

Example 1. (i) On January 1, 2001, A transfers assets X, Y, and Z to B in exchange for assets D, E, and F plus $1,000 cash.

(ii) Assume the exchange of assets constitutes an exchange of like-kind property to which section 1031 applies. Assume also that goodwill or going concern value could under any circumstances attach to each of the DEF and XYZ groups of assets and, therefore, each group constitutes a trade or business under section 1060.

(iii) Assume the fair market values of the assets and the amount of money transferred are as follows:

Asset	Fair market value
By A:	
X	$ 400
Y	400
Z	200
Total	1,000
By B:	
D	40
E	30
F	30
Cash (amount)	1,000
Total	1,100

(iv) Under paragraph (b)(8) of this section, for purposes of allocating consideration under paragraph (c) of this section, the like-kind assets exchanged and any money or other property that are treated as transferred in exchange for the like-kind property are excluded from the application of section 1060.

(v) Since assets X, Y, and Z are like-kind property, they are excluded from the application of the section 1060 allocation rules.

(vi) Since assets D, E, and F are like-kind property, they are excluded from the application of the section 1060 allocation rules. Thus, the allocation rules of section 1060 do not apply in determining B's gain or loss with respect to the disposition of assets D, E, and F, and the allocation rules of section 1060 and paragraph (c) of this section are not applied to determine A's bases of assets D, E, and F. In addition, $900 of the $1,000 cash B gave to A for A's like-kind assets (X, Y, and Z) is treated as transferred in exchange for the like-kind property in order to equalize the fair market values of the like-kind assets. Therefore, $900 of the cash is excluded from the application of the section 1060 allocation rules.

(vii) $100 of the cash is allocated under section 1060 and paragraph (c) of this section.

(viii) A received $100 that must be allocated under section 1060 and paragraph (c) of this section. Since A transferred no Class I, II, III, IV, V, or VI assets to which section 1060 applies, in determining its amount realized for the part of the exchange to which section 1031 does not apply, the $100 is allocated to Class VII assets (goodwill and going concern value).

(ix) B gave A $100 that must be allocated under section 1060 and paragraph (c) of this section. Since B received from A no Class I, II, III, IV, V, or VI assets to which section 1060 applies, the $100 consideration is allocated by B to Class VII assets (goodwill and going concern value).

Example 2. (i) On January 1, 2001, S, a sole proprietor, sells to P, a corporation, a group of assets that constitutes a trade or business under paragraph (b)(2) of this section. S, who plans to retire immediately, also executes in P's favor a covenant not to compete. P pays S $3,000 in cash and assumes $1,000 in liabilities. Thus, the total consideration is $4,000.

(ii) On the purchase date, P and S also execute a separate agreement that states that the fair market values of the Class II, Class III, Class V, and Class VI assets S sold to P are as follows:

Asset class	Asset	Fair market value
II	Actively traded securities	$500
	Total Class II	500
III	Accounts receivable	200
	Total Class III	200
V	Furniture and fixtures	800
	Building	800
	Land	200
	Equipment	400
	Total Class V	2,200
VI	Covenant not to compete	900
	Total Class VI	900

(iii) P and S each allocate the consideration in the transaction among the assets transferred under paragraph (c) of this section in accordance with the agreed upon fair market values of the assets, so that $500 is allocated to Class II assets, $200 is allocated to the Class III asset, $2,200 is allocated to Class V assets, $900 is allocated to Class VI assets, and $200 ($4,000 total consideration less $3,800 allocated to assets in Classes II, III, V, and VI) is allocated to the Class VII assets (goodwill and going concern value).

(iv) In connection with the examination of P's return, the Commissioner, in determining the fair market values of the assets transferred, may disregard the parties' agreement. Assume that the Commissioner correctly determines that the fair market value of the covenant not to compete was $500. Since the allocation of consideration among Class II, III, V, and VI assets results in allocation up to the fair market value limitation, the $600 of unallocated consideration resulting from the Commissioner's redetermination of the value of the covenant not to compete is allocated to Class VII assets (goodwill and going concern value).

(e) *Reporting requirements*—(1) *Applicable asset acquisitions*—(i) *In general.* Unless otherwise excluded from this requirement by the Commissioner, the seller and the purchaser in an applicable asset acquisition each must report information concerning the amount of consideration in the transaction and its allocation among the assets transferred. They also must report information concerning subsequent adjustments to consideration.

(ii) *Time and manner of reporting*—(A) *In general.* The seller and the purchaser each must file asset acquisition statements on Form 8594, ''Asset Allocation Statement,'' with their income tax returns or returns of income for the taxable year that includes the first date

assets are sold pursuant to an applicable asset acquisition. This reporting requirement applies to all asset acquisitions described in this section. For reporting requirements relating to asset acquisitions occurring before March 16, 2001, as described in paragraph (a)(2) of this section, see the temporary regulations under section 1060 in effect prior to March 16, 2001 (see 26 CFR part 1 revised April 1, 2000).

(B) *Additional reporting requirement.* When an increase or decrease in consideration is taken into account after the close of the first taxable year that includes the first date assets are sold in an applicable asset acquisition, the seller and the purchaser each must file a supplemental asset acquisition statement on Form 8594 with the income tax return or return of income for the taxable year in which the increase (or decrease) is properly taken into account.

(C) *Election described in § 1.338–6(c)(5)—(1) Availability.* The election described in §1.338–6(c)(5) is available in respect of an applicable asset acquisition provided that the requirements of that section are satisfied. Such election may be made by the seller, regardless of whether the purchaser also makes the election, and may be made by the purchaser, regardless of whether the seller also makes the election.

(*2*) *Time and manner of making election.* The election described in §1.338–6(c)(5) is made by taking a position on a timely filed original tax return for the taxable year of the applicable asset acquisition that is consistent with having made the election.

(*3*) *Irrevocability of election.* The election described in §1.338–6(c)(5) is irrevocable.

(*4*) *Effective/applicability date.* This paragraph (e)(1)(ii)(C) applies to applicable asset acquisitions occurring on or after September 11, 2007. For applicable asset acquisitions occurring before September 11, 2007 and on or after September 15, 2004, see §1.1060–1T as contained in 26 CFR Part 1 in effect on April 1, 2007. For applicable asset acquisitions occurring before September 15, 2004, see §§1.338–6 and 1.1060–1 as contained in 26 CFR Part 1 in effect on April 1, 2004.

(2) *Transfers of interests in partnerships.* For reporting requirements relating to the transfer of a partnership interest, *see* §1.755–1(d).

[T.D. 8940, 66 FR 9954, Feb. 13, 2001, as amended by T.D. 9059, 68 FR 34299, June 9, 2003; T.D. 9158, 69 FR 55742, Sept. 16, 2004; T.D. 9257, 71 FR 18006, Apr. 10, 2006; T.D. 9358, 72 FR 51706, Sept. 11, 2007; T.D. 9377, 73 FR 3874, Jan. 23, 2008; T.D. 9377, 73 FR 14386, Mar. 18, 2008]

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[T.D. 9945, 86 FR 5480, Jan. 19, 2021]

§ 1.1061–1 Section 1061 definitions.

(a) *Definitions*. The following definitions apply solely for purposes of this section and §§ 1.1061–2 through 1.1061–6.

API Gains and Losses are any long-term capital gains and capital losses with respect to an API and include:

(i) The *API One Year Distributive Share Amount* as defined in § 1.1061–4(a)(3)(i);

(ii) The *API Three Year Distributive Share Amount* as defined in § 1.1061–4(a)(3)(ii);

(iii) The *API One Year Disposition Amount* as defined in § 1.1061–4(a)(4)(i);

(iv) The *API Three Year Disposition Amount* as defined in § 1.1061–4(a)(4)(ii); and

(v) Capital gains or losses from the disposition of Distributed API Property.

API Holder is a person who holds an API.

Applicable Partnership Interest (API) means any interest in a partnership which, directly or indirectly, is transferred to (or is held by) an Owner Taxpayer or Passthrough Taxpayer in connection with the performance of substantial services by the Owner Taxpayer or by a Passthrough Taxpayer, or by any Related Person, including services performed as an employee, in any ATB unless an exception in § 1.1061–3 applies. For purposes of defining an API under this section and section 1061 of the Internal Revenue Code (Code), an interest in a partnership also includes any financial instrument or contract, the value of which is determined in whole or in part by reference to the partnership (including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations). An Owner Taxpayer and a Passthrough Taxpayer can hold an API directly or indirectly through one or more Passthrough Entities.

Applicable Trade or Business (ATB) means any activity for which the ATB Activity Test with respect to Specified Actions is met, and includes all Specified Actions taken by Related Persons, including combining activities occurring in separate partnership tiers or entities as one ATB.

ATB Activity Test has the meaning provided in § 1.1061–2(b)(1).

Capital account means a capital account maintained under § 1.704–1(b)(2)(iv) or similar principles.

Capital Interest Allocations means, with respect to a partnership, allocations of long-term capital gain or loss made under the partnership agreement to an API Holder and to Unrelated Non-Service Partners based on such partners' capital contributed with respect to the partnership to the extent such allocations otherwise meet the requirements of § 1.1061–3(c). With respect to other Passthrough Entities, the principles of this definition apply.

Capital Interest Disposition Amount has the meaning provided in § 1.1061–3(c)(4).

Capital Interest Gains and Losses has the meaning provided in § 1.1061–3(c)(2).

Distributed API Property means property distributed by a Passthrough Entity to an API Holder with respect to an API if the holding period, as determined under sections 735 and 1223, in the API Holder's hands is three years or less at the time of disposition of the property by the API Holder.

Indirect API means an API that is held through one or more Passthrough Entities.

Investing or Developing Actions means actions involving either—

(i) Investing in (or disposing of) Specified Assets (or identifying Specified Assets for such investing or disposition); or

(ii) Developing Specified Assets (see § 1.1061–2(b)(1)(ii)).

Lookthrough Rule means the recharacterization rule described in § 1.1061–4(b)(9).

One Year Gain Amount has the meaning provided in § 1.1061–4(a)(2)(i).

Owner Taxpayer means the person subject to Federal income tax on net gain with respect to an API or an Indirect API during the taxable year, including an owner of a Passthrough Taxpayer unless the owner of the Passthrough Taxpayer is a Passthrough Entity itself or is excepted under § 1.1061–3(a), (b), or (d).

Passthrough Entity means a partnership, trust, estate, S corporation described in § 1.1061–3(b)(2)(i), or passive foreign investment company described in § 1.1061–3(b)(2)(ii).

Passthrough Interest means an interest in a Passthrough Entity that represents in whole or in part an API.

Passthrough Taxpayer means a Passthrough Entity that is treated as a taxpayer for the purpose of determining the existence of an API.

Raising or Returning Capital Actions means actions involving raising or returning capital but does not include Investing or Developing Actions.

Recharacterization Amount has the meaning provided in § 1.1061–4(a)(1).

Related Person means a person or entity who is treated as related to another person or entity under sections 707(b) or 267(b).

Relevant ATB means the ATB in which services were provided and in connection with which an API is held or was transferred.

Section 1061(d) Recharacterization Amount has the meaning provided in § 1.1061–5(c).

Section 1061(d) Related Person has the meaning provided in § 1.1061–5(e).

Section 1061 Regulations means the provisions of this section and §§ 1.1061–2 through 1.1061–6.

Specified Actions means the combination of Raising or Returning Capital Actions and Investing or Developing Actions.

Specified Assets means—

(i) Securities, including interests in partnerships qualifying as securities (as defined in section 475(c)(2) without regard to the last sentence thereof);

(ii) Commodities (as defined in section 475(e)(2));

(iii) Real estate held for rental or investment;

(iv) Cash or cash equivalents; and

(v) An interest in a partnership to the extent that the partnership holds Specified Assets. See § 1.1061–2(b)(1)(iii).

(vi) Specified Assets include options or derivative contracts with respect to any of the items provided in paragraphs (i) through (v) of this definition.

Three Year Gain Amount has the meaning provided in § 1.1061–4(a)(2)(ii).

Unrealized API Gains and Losses means, with respect to a Passthrough Entity's assets, all unrealized capital gains and losses that would be:

(i) Realized if those assets were disposed of for fair market value in a taxable transaction on the relevant date; and

(ii) Allocated to an API Holder with respect to its API, taking into account the principles of section 704(c).

Unrelated Non-Service Partners means partners who do not (and did not) provide services in the Relevant ATB and who are not (and were not) Related Persons with respect to any API Holder in the partnership or any person who provides or has provided services in the Relevant ATB.

(b) *Applicability date*. The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they consistently apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

[T.D. 9945, 86 FR 5480, Jan. 19, 2021]

§ 1.1061–2 Applicable partnership interests and applicable trades or businesses.

(a) *API rules and examples*—(1) *Rules*—(i) *An API remains an API*. Once a partnership interest qualifies as an API, the partnership interest remains an API unless and until the requirements of one of the exceptions to qualification of a partnership interest as an API, set forth in § 1.1061–3, are satisfied.

(ii) *Application of section 1061 to Unrealized API Gains and Losses*. Unrealized API Gains and Losses are API Gains and Losses subject to section 1061 when the gains and losses are realized and recognized. Unrealized API Gains and

Losses do not lose their character as such until they are recognized.

(iii) *API Gains and Losses retain their character*. API Gains and Losses retain their character as API Gains and Losses as they are allocated from one Passthrough Entity to another Passthrough Entity and then to the Owner Taxpayer.

(iv) *Substantial services by an Owner Taxpayer, Passthrough Taxpayer, or any Related Person*. If an interest in a partnership is transferred to or held by an Owner Taxpayer, Passthrough Taxpayer, or any Related Person in connection with the performance of services, the Owner Taxpayer, the Passthrough Taxpayer, or the Related Person is presumed to have provided substantial services for purposes of section 1061.

(v) *Grantor trusts and entities disregarded as separate from their owners*. A trust wholly described in subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code (that is, a grantor trust), a qualified subchapter S subsidiary described in section 1361(b)(3), and an entity with a single owner that is treated as disregarded as an entity separate from its owner under any provision of the Internal Revenue Code or any part of 26 CFR (including § 301.7701–3 of this chapter) are disregarded for purposes of the Section 1061 Regulations.

(2) *Examples*. The following examples illustrate the provisions of this paragraph (a).

(i) *Example 1: API*. (A) A is the general partner of PRS, a partnership, and provides services to PRS. A is engaged in an ATB as defined in § 1.1061–1(a). PRS transfers a PRS profits interest to A in connection with A's performance of substantial services with respect to PRS's ATB. A's interest in PRS is an API.

(B) After 6 years, A retires and is no longer engaged in an ATB and does not perform any services with respect to its ATB and with respect to PRS. However, A retains the API in PRS. PRS continues to acquire new capital assets and to allocate gain to A from the disposition of those assets. Under paragraph (a)(1)(i) of this section, A's interest in PRS remains an API after A retires.

(ii) *Example 2: Contribution of an API to a partnership*. Individuals A, B, and C each directly hold APIs in PRS, a partnership. A and B form a new partnership, GP, and contribute their APIs in PRS to GP. Following the contribution, each of A and B holds an Indirect API because each of A and B now indirectly holds an API in PRS through GP, a Passthrough Entity. Each of A's and B's interests in GP is a Passthrough Interest because each of A's and B's interest in GP represents an Indirect API.

(iii) *Example 3: Passthrough Interest, Indirect API, Passthrough Taxpayer*. Each of A, B, and C provides services to, and is an equal partner in, GP. GP is engaged in an ATB as defined in § 1.1061–1(a), is the general partner of PRS, and provides substantial management services to PRS. In connection with GP's performance of substantial services in an ATB, PRS issues a profits interest to GP. Because GP's PRS interest was received in connection with GP's providing services in an ATB, GP is a Passthrough Taxpayer and GP's interest in PRS is an API. Because A, B, and C are partners in GP, they each hold a Passthrough Interest in GP and an Indirect API in PRS. Each of A, B, and C is treated as an Owner Taxpayer because each is a partner in GP and because each holds an Indirect API in PRS in connection with the performance of its services to GP's ATB.

(iv) *Example 4: S corporation, Passthrough Interest, Indirect API, and Passthrough Taxpayer*. A owns all of the stock of S Corp, an S corporation. S Corp is engaged in an ATB, as defined in § 1.1061–1(a). S Corp is the general partner of PRS, a partnership, and provides substantial management services to PRS. A provides substantial services in S Corp's ATB. In connection with S Corp providing substantial services to PRS, PRS issues a profits interest to S Corp. S Corp's interest in PRS is its only asset. Because S Corp's profits interest in PRS was issued to S Corp in connection with substantial services in an ATB, S Corp is a Passthrough Taxpayer and its interest in PRS is an API. Because A is a shareholder in S Corp, A holds a Passthrough Interest in S Corp and an Indirect API in PRS as

a result of S Corp's API in PRS. A is treated as an Owner Taxpayer because A holds an interest in S Corp, a Passthrough Taxpayer, and also indirectly holds an API in PRS in connection with A's services in S Corp's ATB.

(v) *Example 5: Indirect API, Related Person, and Passthrough Taxpayer*. Each of A, B, and C is an equal partner in partnership GP, the general partner of PRS. GP's Specified Actions do not satisfy the ATB Activity Test under §1.1061–1(a) and as a result, GP's actions do not establish an ATB. Management Company is a Related Person with respect to GP within the meaning of sections 267(b) and 707(b), is engaged in an ATB, and provides substantial management services to PRS that are sufficient to satisfy the ATB Activity Test. Management Company's actions are attributed to GP under paragraphs (a)(1)(iv) and (b)(1)(i)(C) of this section because Management Company is a Related Person to GP. In connection with Management Company's services to PRS, PRS issues a profits interest to GP. Because its PRS profits interest is issued to GP in connection with services provided by Management Company, a Related Person, GP is a Passthrough Taxpayer and its interest in PRS is an API. Unless an exception described in §1.1061–3 applies, because A, B, and C are partners in GP, they each hold a Passthrough Interest in GP and an Indirect API in PRS. A, B, and C are treated as Owner Taxpayers because they hold an interest in GP, a Passthrough Taxpayer.

(b) *Application of the ATB Activity Test*—(1) *In general*. The ATB Activity Test is satisfied if both Raising and Returning Actions and Investing or Developing Actions are conducted by an Owner Taxpayer, Passthrough Taxpayer, or one or more Related Persons with respect to an Owner Taxpayer or Passthrough Taxpayer, and the total level of activity, including the combined activities of all Related Persons, satisfies the level of activity that would be required to establish a trade or business under section 162.

(i) *Rules for applying the ATB Activity Test*—(A) *Aggregate Specified Actions taken into account*. The determination of whether the ATB Activity Test is satisfied is based on the combined activities conducted that qualify as either Raising or Returning Capital Actions and Investing or Developing Actions. The fact that either Raising or Returning Capital Actions or Investing or Developing Actions are only infrequently taken does not preclude the test from being satisfied if the combined Specified Actions meet the test.

(B) *Raising or Returning Capital Actions and Investing or Developing Actions are not both required to be taken in each taxable year*. Raising or Returning Capital Actions and Investing or Developing Actions are not both required to be taken in each taxable year in order to satisfy the ATB Activity Test. For example, the ATB Activity Test will be satisfied if Investing or Developing Actions are not taken in the current taxable year, but sufficient Raising or Returning Capital Actions are taken in anticipation of future Investing or Developing Actions. Additionally, the ATB Activity Test will be satisfied if no Raising or Returning Capital Actions are taken in the current taxable year, but have been taken in a prior taxable year (regardless of whether the ATB Activity Test was met in the prior year), and sufficient Investing or Developing Actions are undertaken by the taxpayer in the current taxable year.

(C) *Combined conduct by multiple related entities taken into account*—(*1*) *Related Entities*. If a Related Person(s) (within the meaning of §1.1061–1(a)) solely or primarily performs Raising or Returning Capital Actions and one or more other Related Person(s) solely or primarily performs Investing or Developing Actions, the combination of the activities performed by these Related Persons will be taken into account in determining whether the ATB Activity Test is satisfied.

(*2*) *Actions taken by an agent or delegate*. Specified Actions taken by an agent or a delegate in its capacity as an agent or a delegate of a principal will be taken into account by the principal in determining whether the ATB Activity Test is satisfied with respect to the principal. These Specified Actions are also taken into account in determining whether the ATB Activity test is satisfied with respect to the agent or the delegate.

(ii) *Developing Specified Assets*. Developing Specified Assets takes place if it is represented to investors, lenders, regulators, or other interested parties that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider. Merely exercising voting rights with respect to shares owned or similar activities do not amount to developing Specified Assets.

(iii) *Partnerships*. Investing or Developing Actions directly conducted with respect to Specified Assets held by a partnership are counted towards the ATB Activity Test. Additionally, a portion of the Investing or Developing Actions conducted with respect to the interests in a partnership that holds Specified Assets is counted towards the ATB Activity Test. This portion is the value of the partnership's Specified Assets over the value of all of the partnership's assets. Actions taken to manage a partnership's working capital will not be taken into account in determining the portion of Investing or Developing Actions conducted with respect to the interests in the partnership.

(2) *Examples*. The following examples illustrate the application of the ATB Activity Test described in paragraph (b)(1) of this section.

(i) *Example 1: Combined activities of Raising or Returning Capital Actions and Investing or Developing Actions*. During the taxable year, B takes a small number of actions to raise capital for new investments. B takes numerous actions to develop Specified Assets. B's actions with respect to raising capital and B's actions with respect to developing Specified Assets are combined for the purpose of determining whether the ATB Activity Test is satisfied. These actions cumulatively rise to the level required to establish a trade or business under section 162. Thus, B satisfies the ATB Activity Test.

(ii) *Example 2: Combining Specified Actions in multiple entities*. GP, a partnership, conducts Raising or Returning Capital Actions. Management Company, a partnership that is a Related Person to GP, conducts Investing or Developing Actions. When GP's and Management Company's activities are combined, the ATB Activity Test is satisfied. Accordingly, both GP and Management Company are engaged in an ATB, and services performed by either GP or Management Company are performed in an ATB under paragraph (b)(1) of this section.

(iii) *Example 3: Investing or Developing Actions taken after Raising or Returning Capital Actions that do not meet the ATB Activity Test*. In year 1, PRS engaged in Raising or Returning Capital Actions to fund PRS's investment in Specified Assets. However, PRS' Specified Actions during year 1 did not satisfy the ATB Activity Test because they did not satisfy the level of activity required to establish a trade or business under section 162. Therefore, PRS was not engaged in an ATB in year 1. In year 2, PRS engaged in significant Investing or Developing Actions but did not engage in any Raising or Returning Capital Actions. In year 2, PRS's Investing or Developing Actions rise to the level required to establish a trade or business under section 162. Because PRS has cumulatively engaged in both Investing or Developing Actions and Raising or Returning Capital Actions and because the Specified Actions rise to the level of activity required to establish a trade or business under section 162, PRS is engaged in an ATB in year 2.

(iv) *Example 4: Raising or Returning Capital Actions taken in anticipation of Investing or Developing Actions*. In year 1, A only conducted Raising or Returning Capital Actions. A's Raising or Returning Capital Actions were undertaken to raise capital to invest in Specified Assets with the goal of increasing their value through Investing or Developing Actions and rise to the level of activity required to establish a trade or business under section 162. A did not take Investing or Developing Actions during the taxable year. A's Raising or Returning Capital Actions satisfy the ATB Activity Test because they were undertaken in anticipation of also engaging in Investing or Developing Actions. Therefore, the ATB Activity Test is satisfied, and A is engaged in an ATB in year 1.

(v) *Example 5: Attribution of delegate's actions*. GP is the general partner of PRS. GP is responsible for providing

management services to PRS. GP contracts with Management Company to provide management services on GP's behalf to PRS. GP and Management Company are not Related Persons. The Specified Actions taken by Management Company on behalf of GP are attributed to GP for purposes of the ATB Activity Test because the Management Company is operating as a delegate of GP. Additionally, those Specified Actions are taken into account by Management Company for purposes of the ATB Activity Test and whether it is engaged in an ATB.

(vi) *Example 6: ATB Activity Test not satisfied.* A is the manager of a hardware store. Partnership owns the hardware store, including the building in which the hardware business is conducted. In connection with A's services as the manager of the hardware store, a profits interest in Partnership is transferred to A. Partnership's business involves buying hardware from wholesale suppliers and selling it to customers. The hardware is not a Specified Asset. Although real estate is a Specified Asset if it is held for rental or investment purposes, Partnership holds the building for the purpose of conducting its hardware business and not for rental or investment purposes. Therefore, the building is not a Specified Asset as to Partnership. Partnership also maintains and manages a certain amount of working capital for its business, but actions with respect to working capital are not taken into account for the purpose of determining whether the ATB Activity Test is met. Partnership is not a Related Person with respect to any person who takes Specified Actions. Partnership is not engaged in an ATB because the ATB Activity Test is not satisfied. Although Partnership raises capital, its Raising or Returning Capital Actions alone do not satisfy the ATB Activity Test. Further, Partnership takes no Investing or Developing Actions because it holds no Specified Assets other than working capital. Partnership is not in an ATB and the profits interest transferred to A is not an API.

(c) *Applicability date.* The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

[T.D. 9945, 86 FR 5480, Jan. 19, 2021]

§ 1.1061–3 Exceptions to the definition of an API.

(a) *A partnership interest held by an employee of another entity not conducting an ATB.* An API does not include any interest transferred to a person in connection with the performance of substantial services by that person as an employee of another entity that is conducting a trade or business (other than an ATB) and the person provides services only to such other entity.

(b) *Partnership interest held by a corporation*—(1) *In general.* An API does not include any interest directly or indirectly held by a corporation.

(2) *Treatment of interests held by an S corporation or a qualified electing fund.* For purposes of this section, a corporation does not include an entity for which an election was made to treat the entity as a Passthrough Entity. Thus, the following entities are not treated as corporations for purposes of section 1061—

(i) An S corporation for which an election under section 1362(a) is in effect; and

(ii) A passive foreign investment company (PFIC) with respect to which the shareholder has a qualified electing fund (QEF) election under section 1295 in effect.

(c) *Capital Interest Gains and Losses*—(1) *In general.* Capital Interest Gains and Losses are not subject to section 1061 and, therefore, are not included in calculating an Owner Taxpayer's Recharacterization Amount.

(2) *Capital Interest Gains and Losses defined.* For purposes of paragraph (c)(1) of this section, Capital Interest Gains and Losses are Capital Interest Allocations that meet the requirements of paragraph (c)(3) of this section and Capital Interest Disposition Amounts that meet the requirements of paragraph (c)(4) of this section.

(3) *General rules for determining Capital Interest Allocations*—(i) *Commensurate with capital contributed.* An allocation will be considered a Capital Interest Allocation if the allocation to the API Holder with respect to its capital interest is determined and calculated in a similar manner as the allocations with respect to capital interests held by similarly situated Unrelated Non-Service Partners who have made significant aggregate capital contributions as described in paragraph (c)(3)(iv) of this section. For purposes of this paragraph (c)(3), a capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value at the time the interest was received and the proceeds were then distributed in a complete liquidation of the partnership.

(ii) *In a similar manner.* For purposes of paragraph (c)(3)(i) of this section, a Capital Interest Allocation to an API Holder will be treated as made in a similar manner if allocations and distribution rights with respect to the capital contributed by an API Holder to which the API Holder's Capital Interest Allocation relates are reasonably consistent with allocation and distribution rights with respect to capital contributed by Unrelated Non-Service Partners where the Unrelated Non-Service Partner requirement is met. For purposes of this paragraph (c)(3)(ii), allocation and distribution rights for an API Holder that are limited to a particular class of partnership capital interests or that are determined with respect to capital contributions invested in a particular partnership investment will be considered as made in a similar manner to allocations and distribution rights of Unrelated Non-Service Partners where the Unrelated Non-Service Partner requirement is met for the applicable interest class or partnership investment.

(A) *Relevant factors.* For purposes of this paragraph (c)(3)(ii), the following factors are not exclusive, but are relevant factors in determining whether allocation and distribution rights with respect to capital contributed by an API Holder are reasonably consistent with allocation and distribution rights of persons meeting the Unrelated Non-Service Partner requirement: The amount and timing of capital contributed, the rate of return on capital contributed, the terms, priority, type and level of risk associated with capital contributed, and the rights to cash or property distributions during the partnership's operations and on liquidation. Accordingly, an allocation to an API Holder will not fail to qualify solely because the allocation is subordinated to allocations made to Unrelated Non-Service Partners, because an allocation to an API Holder is not reduced by the cost of services provided by the API Holder or a Related Person to the partnership, where the cost of services provided includes management fees or API allocations, or because an API Holder has a right to receive tax distributions while Unrelated Non-Service Partners do not, where such distributions are treated as advances against future distributions.

(B) *Clear identification requirement.* For purposes of this paragraph (c)(3)(ii), allocations will be considered made in a similar manner only if the allocations to the API Holder and the Unrelated Non-Service Partners are allocations with respect to, and corresponding to, such partners' contributed capital that are separate and apart from allocations made to the API Holder with respect to its API and where both the partnership agreement and the partnership's contemporaneous books and records clearly demonstrate that the requirements of paragraph (c)(3) of this section have been met.

(iii) *Reinvestment of API Gain.* If an API Holder is allocated API Gain by a Passthrough Entity, to the extent that an amount equal to the API Gain is reinvested in the Passthrough Entity by the API Holder (either as the result of an actual distribution and recontribution of the API Gain amount or the retention of the API Gain amount by the Passthrough Entity), the amount will be treated as a contribution to the Passthrough Entity for a capital interest that may produce Capital Interest Allocations for the API Holder, provided such allocations meet the requirements of this paragraph (c)(3).

(iv) *Unrelated Non-Service Partner requirement.* For purposes of paragraph (c)(3) of this section, the Unrelated

Non-Service Partner requirement means that Unrelated Non-Service Partners must have made significant aggregate capital contributions in relation to total capital contributions of all partners. Unrelated Non-Service Partners will be treated as having made significant aggregate capital contributions provided such partners possess five percent or more of the aggregate capital contributed to the partnership at the time the allocations are made. With respect to an API Holder with allocation and distribution rights that are attributable to a particular interest class or partnership investment, the Unrelated Non-Service requirement must be met with respect to that particular interest class or partnership investment.

(v) *Proceeds of certain loans not taken into account for Capital Interest Allocation purposes*—(A) *General rule*. For purposes of the Section 1061 Regulations, an allocation is not a Capital Interest Allocation to the extent the allocation is attributable to the contribution of an amount of capital to a partnership that, directly or indirectly, results from, or is attributable to, any loan or other advance made or guaranteed, directly or indirectly, by the partnership, a partner in the partnership, or any Related Person with respect to such persons, except to the extent a loan or advance is described in paragraph (c)(3)(v)(B) of this section. However, the repayments on a loan described in the preceding sentence are taken into account as capital contributed (and may therefore generate Capital Interest Allocations) as those amounts are paid by the partner, provided that the loan is not repaid with the proceeds of another loan described in the preceding sentence.

(B) *Recourse liability*. Paragraph (c)(3)(v)(A) of this section does not apply with respect to an allocation attributable to a contribution made by an individual service provider that, directly or indirectly, results from, or is attributable to, a loan or advance from another partner in the partnership (or any Related Person with respect to such lending or advancing partner, other than the partnership) to such individual service provider if the individual service provider is personally liable for the repayment of such loan or advance. A contribution made by an individual service provider includes a contribution made by an entity that is wholly owned by, and disregarded as separate from, the individual service provider as described in §1.1061–2(a)(1)(v), including a contribution attributable to a loan or advance made to the disregarded entity by another partner in the partnership (or any Related Person with respect to such lending or advancing partner, other that the partnership) if the individual service provider is personally liable for the repayment of any and all borrowed amounts that are not repaid by the disregarded entity. For purposes of this paragraph (c)(3)(v)(B), an individual service provider is personally liable for the repayment of a loan or advance made by a partner (or any Related Person, other than the partnership) if—

(*1*) The loan or advance is fully recourse to the individual service provider;

(*2*) The individual service provider has no right to reimbursement from any other person; and

(*3*) The loan or advance is not guaranteed by any other person.

(vi) *Items that are not included in Capital Interest Allocations*. Capital Interest Allocations do not include—

(A) Amounts that are treated as API Gains and Losses and Unrealized API Gains and Losses; or

(B) Items that are not taken into account for purposes of section 1061 under §1.1061–4(b)(7).

(4) *Capital Interest Disposition Amounts*—(i) *In general*. The term *Capital Interest Disposition Amount* means the amount of long-term capital gain or loss recognized on the sale or disposition of all or a portion of a Passthrough Interest that is treated as Capital Interest Gain or Loss. In general, long-term capital gain or loss recognized on the sale or disposition of a Passthrough Interest is deemed to be API Gain or Loss unless it is determined under paragraph (c)(4)(ii) of this section to be a Capital Interest Disposition Amount.

(ii) *Determination of the Capital Interest Disposition Amount*. If a Passthrough Interest that includes a right to allocations of Capital Interest Gains and

Losses is disposed of, the amount of long-term capital gain or loss that is treated as a Capital Interest Disposition Amount is determined under the rules provided in this paragraph (c)(4)(ii).

(A) First, determine the amount of long-term capital gain or loss that would be allocated to the Passthrough Interest (or the portion of the Passthrough Interest sold) if all the assets of the Passthrough Entity (including gain or loss with respect to assets described in §1.1061–4(b)(7)) were sold for their fair market value in a fully taxable transaction immediately before the disposition of the Passthrough Interest (hypothetical asset sale). For purposes of this paragraph (c)(4)(ii), the assets of the Passthrough Entity include any assets held by a lower-tier Passthrough Entity in which the Passthrough Entity has a direct or indirect interest.

(B) Second, determine the amount from the hypothetical asset sale that would be allocated to the Passthrough Interest (or the portion of the Passthrough Interest sold) as Capital Interest Allocations under paragraph (c)(3) of this section.

(C) Third, if the transferor recognized long-term capital gain upon disposition of the Passthrough Interest and only net short-term capital losses, net long-term capital losses, or both, are allocated to the Passthrough Interest under paragraph (c)(4)(ii)(B) of this section from the hypothetical asset sale, all of the long-term capital gain is API Gain. If the transferor recognized long-term capital loss on the disposition of the Passthrough Interest and only net short-term capital gains, net long-term capital gains, or both, are allocated to the Passthrough Interest under paragraph (c)(4)(ii)(B) of this section, then all the long-term capital loss is API Loss.

(D) If paragraph (c)(4)(ii)(C) of this section does not apply and long-term capital gain is recognized on the disposition of the Passthrough Interest, the amount of long-term capital gain that the transferor of the Passthrough Interest recognizes that is treated as a Capital Interest Disposition Amount is determined by multiplying long-term capital gain recognized on the disposition of the Passthrough Interest by a fraction, the numerator of which is the amount of long-term capital gain determined under paragraph (c)(4)(ii)(B) of this section, and the denominator of which is the amount of long-term capital gain determined under paragraph (c)(4)(ii)(A) of this section, with the percentage represented by the fraction limited to 100 percent. Alternatively, if paragraph (c)(4)(ii)(C) of this section does not apply and long-term capital loss is recognized on the disposition of the Passthrough Interest, the amount of long-term capital loss treated as a Capital Interest Disposition Amount is determined by multiplying the transferor's capital loss by a fraction, the numerator of which is the amount of long-term capital loss determined under paragraph (c)(4)(ii)(B) of this section, and the denominator of which is the amount of long-term capital loss determined under paragraph (c)(4)(ii)(A) of this section, with the percentage represented by the fraction limited to 100 percent.

(E) In applying this paragraph (c)(4)(ii), allocations of amounts that are not included in determining the amount of long-term capital gain or loss recognized on the sale or disposition of the Passthrough Interest are not included. See, for example, section 751(a).

(5) *Capital Interest Allocations made by a Passthrough Entity that is an API Holder*. An allocation made to a Passthrough Entity that holds an API in a lower-tier Passthrough Entity will be considered a Capital Interest Allocation if it meets the principles set forth in paragraphs (c)(3) and (4) of this section (other than paragraph (c)(3)(iv) of this section). For purposes of applying the Capital Interest Allocation rules in this paragraph (c)(5) to a tiered partnership structure, to the extent that a Capital Interest Allocation that is made by a lower-tier partnership to an upper-tier partnership is properly allocated to the upper-tier partnership's partners with respect to their capital interests in the upper-tier partnership in a manner that is respected under 704(b) (taking into account the principles of section 704(c)), such allocation is a Capital Interest Allocation.

(6) *Examples*. The rules of this paragraph (c) are illustrated by the following examples.

(i) *Example 1: Capital Interest Allocations*—(A) *Facts*. Each of A, B, and C contributes $100 to GP and is an equal partner in GP, a partnership that is the general partner of PRS, a partnership. The contributions are not attributable to loans or advances described in paragraph (c)(3)(v)(A) of this section. PRS's other partners are Unrelated Non-Service Partners. Each of GP and PRS makes allocations to its partners in accordance with its partners' interests in that partnership, as described in § 1.704–1(b)(3). GP holds a 20% profits interest in PRS that is an API that GP received in exchange for providing substantial services to PRS in an ATB. GP's API is an Indirect API to each of A, B, and C. GP contributes the $300 of capital contributed by A, B and C to PRS. GP's $300 contribution equals 2% of the contributed capital made by all of PRS's partners ($15,000). PRS's partnership agreement describes its partners' economic distribution rights with respect to its liquidating proceeds as follows: First, liquidating proceeds are proportionately distributed to each of GP and the Unrelated Non-Service Partners equal to the amount necessary to return each of those partners' unreturned capital; second, liquidating proceeds are distributed to GP with respect to its API in PRS; and, finally, any residual liquidating proceeds are distributed, proportionately, 98% to the Unrelated Non-Service Partners and 2% to GP. During its initial taxable year, PRS has $10,000 of net capital gain, causing an increase in PRS's distributable proceeds of $10,000. In accordance with the partners' economic rights as described in PRS's partnership agreement, PRS allocates $2,160 of net capital gain to GP (a $2,000 API allocation plus $160 ($8,000 ($10,000 − $2,000) × 2%), with respect to GP's contributed capital) and $7,840 of net capital gain to the Unrelated Non-Service Partners with respect to their contributed capital. GP allocates $720 ($2,160/3) of this net capital gain to each of A, B, and C in accordance with their interests in GP.

(B) *PRS's Capital Interest Allocation Analysis*. Because PRS's partnership agreement provides for no differences as to the amount and timing of capital contributed, the rate of return on capital contributed, the type and level of risk associated with capital contributed, or the rights to cash or property distributions during the PRS's operations and on liquidation, the allocations and distribution rights with respect the capital contributed by GP are reasonably consistent with the allocation and distribution rights with respect to capital contributed by Unrelated Non-Service Partners. Accordingly, GP's allocation of $160 is a Capital Interest Allocation that is treated as made in a similar manner as the allocations made to the Unrelated Non-Service Partners.

(C) *GP Capital Interest Allocation Analysis*. GP is allocated $2,160 from PRS, consisting of a $2,000 API allocation and a $160 Capital Interest Allocation. The $160 Capital Interest Allocation is allocated equally to A, B, and C based on their capital contributions to GP. Therefore, they qualify as Capital Interest Allocations by GP. See paragraph (c)(5) of this section. The $2,000 of gain allocated by PRS's to GP with respect to GP's API cannot be treated as a Capital Interest Allocation by GP and therefore is subject to section 1061. In summary, A, B, and C are each allocated $720 of capital gain from PRS ($2,160/3). Of this amount, $667 is API Gain ($2,000/3) and $53 is a Capital Interest Allocation ($160/3).

(ii) *Example 2: Sale of a Passthrough Interest*—(A) *Facts*. In Year 1, A, B, and C form GP, a partnership. Each of A, B, and C contributes $100 to GP and is an equal partner in GP. The contributions are not attributable to loans or advances described in paragraph (c)(3)(v)(A) of this section. GP invests the $300 in Asset X in Year 1. GP is also the general partner of PRS, a partnership. PRS's other partners are Unrelated Non-Service Partners. GP holds a 20% profits interest in PRS that is an API that GP received in exchange for providing substantial services to PRS in an ATB. GP's API is an Indirect API to each of A, B, and C. Each of GP and PRS makes allocations to its partners in accordance with its partners' interests in that partnership, as described in

§ 1.704–1(b)(3). In Year 3, A sells A's interest in GP to an unrelated third party for $800 and recognizes $700 of capital gain on the sale. If PRS had sold its assets in a hypothetical asset sale as required by paragraph (c)(4)(ii)(A) of this section and liquidated immediately before A sold its interest in GP, GP would have been allocated $1,800 of long-term capital gain with respect to GP's API in PRS, and GP would have allocated $600 of this $1,800 to A. If GP sold Asset X for its fair market value and liquidated immediately before A sold its interest in GP, A would have been allocated $100 of long-term capital gain.

(B) *Analysis*. GP does not have a capital interest in PRS. Therefore, its allocations from PRS are allocations with respect to its API which are subject to section 1061. The total gain allocable to A as a result of the hypothetical liquidations would be $700. Under paragraph (c)(4)(ii)(D) of this section, $100 of the $700 of A's interest sale gain is A's Capital Interest Disposition Amount, and is not subject to section 1061.

(iii) *Example 3: Reinvestment of Realized API Gain*. A, B, and C are partners in PRS, a partnership. At the beginning of Year 1, A is issued an API in PRS in exchange for providing substantial services to PRS in an ATB. A has no capital interest in PRS. During Year 1, PRS's assets appreciate by $100. At the end of Year 1, under the terms of its partnership agreement, if PRS were to sell all of its assets at their fair market value and distribute the proceeds in a complete liquidation, A would receive $20 with respect to its API. Thus, at the end of Year 1, A has $20 of Unrealized API Gain. In Year 2, PRS sells Asset X, an asset that PRS owned in Year 1, and allocates $8 of the long-term capital gain to A as API Gain. As a result, $8 of A's $20 of Unrealized API Gain becomes API Gain that is subject to section 1061. A reinvests A's share of the proceeds from the Asset X sale in PRS. As a result, under paragraph (c)(3)(iii) of this section, A has an $8 capital interest in PRS and, provided the requirements of paragraph (c)(3) of this section are met, A may receive future Capital Interest Allocations with respect to the capital interest.

(d) *Partnership interest acquired by purchase by an unrelated person*. If a person (acquirer) acquires an interest in a partnership (target partnership) by taxable purchase for fair market value that, but for the exception set forth in this paragraph (d), would be an API, the transferor of the interest will be treated as selling an API but the acquirer will not be treated as acquiring an API if—

(1) *Acquirer not a Related Person*. Immediately before the purchase, the acquirer is not a Related Person with respect to—

(i) Any person who provides services in the Relevant ATB; or

(ii) Any service providers who provide services to, or for the benefit of, the target partnership or a lower-tier partnership in which the target partnership holds an interest, directly or indirectly.

(2) *Section 1061(d) not applicable*. Section 1061(d) does not apply to the transaction (as provided in § 1.1061–5).

(3) *Acquirer not a service provider*. At the time of the purchase, the acquirer has not provided, does not provide, and does not anticipate providing, services in the future, to, or for the benefit of, the target partnership, directly or indirectly, or any lower-tier partnership in which the target partnership directly or indirectly holds an interest.

(e) [Reserved]

(f) *Applicability date*—(1) *General rule*. Except as provided in paragraphs (f)(2) and (3) of this section, the provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

(2) *Partnership interest held by an S corporation*. Paragraph (b)(2)(i) of this section, which provides that the exception under section 1061(c)(1) to the definition of an API does not apply to a partnership interest held by an S corporation with an election under section 1362(a) in effect, applies to taxable

years beginning after December 31, 2017.

(3) *Partnership interest held by a PFIC with respect to which the shareholder has a QEF election in effect.* Paragraph (b)(2)(ii) of this section, which provides that the exception under section 1061(c)(1) to the definition of an API does not apply to a partnership interest held by a PFIC with respect to which the shareholder has a QEF election in effect under section 1295, applies to taxable years of an Owner Taxpayer and Passthrough Entity beginning after August 14, 2020.

[T.D. 9945, 86 FR 5480, Jan. 19, 2021]

§ 1.1061–4 Section 1061 computations.

(a) *Computations*—(1) *Recharacterization Amount.* The Recharacterization Amount is the amount that an Owner Taxpayer must treat as short-term capital gain under section 1061(a). The Recharacterization Amount equals—

(i) The Owner Taxpayer's One Year Gain Amount; less

(ii) The Owner Taxpayer's Three Year Gain Amount.

(2) *One Year Gain Amount and Three Year Gain Amount*—(i) *One Year Gain Amount.* The Owner Taxpayer's One Year Gain Amount is the sum of—

(A) The Owner Taxpayer's combined net API One Year Distributive Share Amount from all APIs held during the taxable year; and

(B) The Owner Taxpayer's API One Year Disposition Amount.

(ii) *Three Year Gain Amount.* The Owner Taxpayer's Three Year Gain Amount is the sum of—

(A) The Owner Taxpayer's combined net API Three Year Distributive Share Amount from all APIs held during the taxable year; and

(B) The Owner Taxpayer's API Three Year Disposition Amount.

(3) *API One Year Distributive Share Amount and API Three Year Distributive Share Amount*—(i) *API One Year Distributive Share Amount.* The API One Year Distributive Share Amount equals—

(A) The API Holder's distributive share of net long-term capital gain or loss from the partnership for the taxable year (including capital gain or loss on the disposition of Distributed API Property by an API Holder that is a Passthrough Entity or the disposition of all or a part of an API by an API Holder that is a Passthrough Entity), with respect to the partnership interest held by the API Holder calculated without the application of section 1061; less

(B) To the extent included in the amount determined under paragraph (a)(3)(i)(A) of this section, the aggregate of—

(*1*) Amounts that are not taken into account for purposes of section 1061 under paragraph (b)(7) of this section; and

(*2*) Capital Interest Gains and Losses as determined under § 1.1061–3(c)(2).

(ii) *API Three Year Distributive Share Amount.* The API Three Year Distributive Share Amount equals the API One Year Distributive Share Amount, less—

(A) Items included in the API One Year Distributive Share Amount that would not be treated as a long-term gain or loss if three years is substituted for one year in paragraphs (3) and (4) of section 1222; and

(B) Any adjustments resulting from the application of the Lookthrough Rule under paragraph (b)(9)(ii) of this section when an API is disposed of by an API Holder that is a Passthrough Entity.

(4) *API One Year Disposition Amount and API Three Year Disposition Amount*—(i) *API One Year Disposition Amount.* The API One Year Disposition Amount is the combined net amount of—

(A) Long-term capital gains and losses recognized during the taxable year by an Owner Taxpayer, including long-term capital gain computed under the installment method that is taken into account for the taxable year, on the disposition of all or a portion of an API that has been held for more than one year, including a disposition to which the Lookthrough Rule applies;

(B) Long-term capital gain and loss recognized by an Owner Taxpayer due to a distribution with respect to an API during the taxable year that is treated under section 731(a) as gain or loss from the sale or exchange of a partnership interest held for more than one year; and,

(C) Long-term capital gains and losses recognized by an Owner Taxpayer on the disposition of Distributed API Property (taking into account deemed exchanges under section 751(b)) during the taxable year that has a holding period of more than one year but not more than three years to the distributee Owner Taxpayer on the date of disposition, excluding items described in paragraph (b)(7) of this section.

(ii) *API Three Year Disposition Amount*. The API Three Year Disposition Amount is the combined net amount of—

(A) Long-term capital gains and losses recognized during the taxable year by an Owner Taxpayer, including long-term capital gain computed under the installment method that is taken into account for the taxable year, on the disposition of all or a portion of an API that has been held for more than three years and to which the Lookthrough Rule does not apply;

(B) Long-term capital gains and losses recognized by an Owner Taxpayer on the disposition during the taxable year of all or a portion of an API that has been held for more than three years in a transaction to which the Lookthrough Rule in paragraph (b)(9) of this section applies, less any adjustments required under the Lookthrough Rule in paragraph (b)(9)(ii) of this section; and

(C) Long-term capital gains and losses recognized on a distribution with respect to an API during the taxable year that is treated under sections 731(a) as gain or loss from the sale or exchange of a partnership interest held for more than three years.

(b) *Special rules for calculating the One Year Gain Amount and the Three Year Gain Amount*—(1) *One Year Gain Amount equals zero or less*. If an Owner Taxpayer's One Year Gain Amount is zero or results in a loss, the Recharacterization Amount for the taxable year is zero and section 1061(a) does not apply.

(2) *Three Year Gain Amount equals zero or less*. If an Owner Taxpayer's Three Year Gain Amount is less than or equal to $0, the Three Year Gain Amount is zero for purposes of calculating the Recharacterization Amount.

(3) *One Year Gain Amount less than Three Year Gain Amount*. If the One Year Gain Amount and the Three Year Gain Amount are both greater than zero but the One Year Gain Amount is less than the Three Year Gain Amount, none of the One Year Gain Amount is included in the Recharacterization Amount for the taxable year.

(4) *Installment sale gain*. The One Year Gain Amount under paragraph (a)(2)(i) of this section and the Three Year Gain Amount, as determined under paragraph (a)(2)(ii) of this section include long-term capital gains from installment sales. This includes long-term capital gain or loss recognized with respect to an API after December 31, 2017, with respect to an installment sale that occurred on or before December 31, 2017. The holding period of the asset upon the date of disposition is used for purposes of determining whether capital gain is included in the taxpayer's One Year Gain Amount or the Three Year Gain Amount.

(5) *Special rules for capital gain dividends from regulated investment companies (RICs) and real estate investment trusts (REITs)*—(i) *API One Year Distributive Share Amount*. If a RIC or REIT reports or designates a dividend as a capital gain dividend and provides the One Year Amounts Disclosure as defined in § 1.1061–6(c)(1)(i), the amount provided in the One Year Amounts Disclosure is included in the calculation of an API One Year Distributive Share Amount. If the RIC or REIT does not provide the One Year Amounts Disclosure, the full amount of the RIC's or REIT's capital gain dividend must be included in the calculation of an API One Year Distributive Share Amount.

(ii) *API Three Year Distributive Share Amount*. If a RIC or REIT reports or designates a dividend as a capital gain dividend and provides the Three Year Amounts Disclosure as defined in § 1.1061–6(c)(1)(ii), the amount provided in the Three Year Amounts Disclosure is used for the calculation of an API Three Year Distributive Share amount. If the RIC or REIT does not provide the Three Year Amounts Disclosure, no amount of the RIC's or REIT's capital gain dividend may be used for the calculation of an API Three Year Distributive Share Amount.

(iii) *Loss on sale or exchange of stock.* If a RIC or REIT provides the Three Year Amounts Disclosure as provided in paragraph (b)(5)(ii) of this section, any loss on the sale or exchange of shares of a RIC or REIT held for six months or less is treated as a capital loss on an asset held for more than three years, to the extent of the amount of the Three Year Amounts Disclosure from that RIC or REIT.

(6) *Pro rata share of qualified electing fund (QEF) net capital gain*—(i) *One year QEF net capital gain.* The calculation of an API One Year Distributive Share Amount includes an Owner Taxpayer's inclusion under section 1293(a)(1)(B) as limited by section 1293(e)(2) with respect to a passive foreign investment company (as defined in section 1297(a)) for which a QEF election (as described in section 1295(a)) is in effect for the taxable year. The amount of the inclusion may be reduced by the amount of long-term capital gain that is not taken into account for purposes of section 1061 as provided in paragraph (b)(7) of this section and may be reduced by the Owner Taxpayer's share of the excess, if any, of the Capital Interest Gain over Capital Interest Loss with respect to the QEF, provided in each case that the relevant information is provided by the QEF. See §1.1061–6 for reporting rules.

(ii) *Three year QEF net capital gain adjustment.* For purposes of calculating an Owner Taxpayer's API Three Year Distributive Share Amount, the entire amount determined under paragraph (b)(6)(i) of this section, after any allowed reduction, is included as an item in paragraph (a)(3)(ii)(A) of this section unless the QEF provides information to determine the amount of the inclusion that would constitute net capital gain (as defined in §1.1293–1(a)(2), as limited by section 1293(e)(2)) if the QEF's net capital gain for the taxable year were calculated under section 1222(11) applying paragraphs (3) and (4) of section 1222 by substituting three years for one year. If such information is provided, the amount included as an item in paragraph (a)(3)(ii)(A) of this section is the amount determined under paragraph (b)(6)(i) of this section that would not be treated as long-term gain if three years were substituted for one year in paragraphs (3) and (4) of section 1222. See §1.1061–6 for reporting rules.

(7) *Items not taken into account for purposes of section 1061.* The following items of long-term capital gain and loss are excluded from the calculation of the API One Year Distributive Share Amount in paragraph (a)(3)(i) of this section and the API Three Year Distributive Share Amount in paragraph (a)(3)(ii) of this section—

(i) Long-term capital gain and long-term capital loss determined under section 1231;

(ii) Long-term capital gain and long-term capital loss determined under section 1256;

(iii) Qualified dividends included in net capital gain for purposes of section 1(h)(11)(B); and

(iv) Capital gains and losses that are characterized as long-term or short-term without regard to the holding period rules in section 1222, such as certain capital gains and losses characterized under the mixed straddle rules described in section 1092(b) and §§1.1092(b)–3T, 1.1092(b)–4T, and 1.1092(b)–6.

(8) *Holding period determination*—(i) *Determination of holding period for purposes of the Three Year Gain Amount.* For purposes of computing the Three Year Gain Amount, the relevant holding period of either an asset or an API is determined under all provisions of the Code or regulations that are relevant to determining whether the asset or the API has been held for the long-term capital gain holding period by applying those provisions as if the holding period were three years instead of one year.

(ii) *Relevant holding period.* The relevant holding period is the direct owner's holding period in the asset sold. Accordingly, for purposes of determining an API Holder's Taxpayer's API One Year Distributive Share Amount and API Three Year Distributive Share Amount for the taxable year under paragraph (a)(3) of this section, the partnership's holding period in the asset being sold or disposed of (whether a directly held asset or a partnership interest) is the relevant holding period for purposes of section 1061.

(9) *Lookthrough Rule for certain API dispositions*—(i) *Determination that the*

Lookthrough Rule applies—(A) *In general*. The Lookthrough Rule will apply if, at the time of disposition of an API held for more than three years—

(*1*) The API would have a holding period of three years or less if the holding period of such API were determined by not including any period before the date that an Unrelated Non-Service Partner is legally obligated to contribute substantial money or property directly or indirectly to the Passthrough Entity to which the API relates. This paragraph (b)(9)(i)(A) does not apply to the disposition of an API to the extent that the gain recognized upon the disposition of the API is attributable to any asset not held for portfolio investment on behalf of third party investors (as defined in section 1061(c)(5)). Solely for the purpose of this paragraph (b)(9)(i)(A), a substantial legal obligation to contribute money or property is an obligation to contribute a value that is at least 5 percent of the partnership's total capital contributions as of the time of the API disposition; or

(*2*) A transaction or series of transactions has taken place with a principal purpose of avoiding potential gain recharacterization under section 1061(a).

(B) *Determination that the Lookthrough Rule applies to the disposition of a Passthrough Interest*. Paragraph (b)(9)(i)(A) of this section similarly applies with respect to a Passthrough Interest issued by an S corporation or a PFIC to the extent the Passthrough Interest is treated as an API.

(ii) *Application of the Lookthrough Rule*. If the Lookthrough Rule applies, for purposes of applying an Owner Taxpayer's Recharacterization Amount, as described in paragraph (a) of this section—

(A) The Owner Taxpayer must include the entire amount of capital gain recognized on the disposition of an API by the Owner Taxpayer in the Owner Taxpayer's API One Year Disposition Amount; and

(B) The Owner Taxpayer must include in its Three Year Disposition Amount an amount equal its One Year Disposition Amount (determined under paragraph (b)(9)(ii)(A) of this section) reduced by the Owner Taxpayer's share of the amount of any gain, directly or indirectly, from assets held for three years or less that would have been allocated to the Owner Taxpayer (to the extent attributable to the transferred API) by the partnership if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the Owner Taxpayer's transfer of the API.

(C) In the case of an API disposition by an API Holder that is a Passthrough Entity and not an Owner Taxpayer, the principles set forth in paragraph (b)(9)(ii)(A) of this section must be applied to determine the amount to include in the Owner Taxpayer's One Year Distributive Amount and in paragraph (b)(9)(ii)(B) of this section to determine the amounts included in the Owner Taxpayer's Three Year Distributive Share Amount.

(10) *Section 83*. Except with respect to any portion of the interest that is a capital interest under § 1.1061–3(c), this section applies regardless of whether an Owner Taxpayer or Passthrough Entity has made an election under section 83(b) or included amounts in gross income under section 83.

(c) *Examples*—(1) *Recharacterization rules*. The rules of paragraph (a) of this section are illustrated by the following examples. Unless otherwise stated, all gains and losses are long-term capital gains and losses, none of the long-term capital gain or loss in this section is capital gain or loss not taken into account for purposes of section 1061 under paragraph (b)(7) of this section, and neither the Lookthrough Rule nor section 751 is applicable.

(i) *Example 1: Determination of API One Year and Three Year Distributive Share Amounts*—(A) *Facts*. A holds an API in PRS but has no capital interest in PRS and is not entitled to a Capital Interest Allocation with respect to PRS. During the taxable year, PRS allocates to A $20 of long-term capital gain from the sale of capital asset X (which had been held by PRS for two years) and $40 of long-term capital gain from the sale of capital asset Y (which had held by PRS for five years). A has

no other items of long-term capital gain or loss with respect to its interest in PRS during the taxable year. A has no other long-term capital gains or losses with respect to any other API during the taxable year.

(B) *Determination of A's API One Year Distributive Share Amount.* Under paragraph (a)(3)(i) of this section, A has an API One Year Distributive Share Amount of $60. This amount is the sum of the $20 of the long-term capital gain allocated to A from PRS's sale of capital asset X and the $40 of long-term capital gain allocated to A from PRS's sale of capital asset Y.

(C) *Determination of A's API Three Year Distributive Share Amount.* (*1*) Under paragraph (a)(3)(ii) of this section, A's API Three Year Distributive Share Amount is equal to A's API One Year Distributive Amount, $60, less the sum of:

(*i*) The items included in the API One Year Distributive Share Amount that would not be treated as a long-term gain or loss if three years is substituted for one year in paragraphs (3) and (4) of section 1222, $20; and

(*ii*) Adjustments resulting from the application of the Lookthrough Rule under paragraph (b)(9)(ii) of this section, which under the facts in paragraph (c)(1)(i)(A) of this section, is inapplicable.

(*2*) Thus, A's Three Year API Distributive Share Amount is $40.

(D) *Determination of A's Recharacterization Amount.* Under paragraph (a)(2)(i) of this section, A's One Year Gain amount is equal to A's API One Year Distributive Share Amount, $60. A's Three Year Gain Amount is equal to A's API Three Year Distributive Share Amount, $40. Under paragraph (a)(1) of this section, A's Recharacterization Amount is A's One Year Gain Amount, minus A's Three Year Gain Amount, or $20.

(ii) *Example 2: API One Year and Three Year Disposition Amounts*—(A) *Facts.* During the taxable year, A disposes of an API that A has held for four years for a $100 gain. Additionally, A sells Distributed API Property for a $300 gain at a time when A has a two-year holding period in such property. A has no other items of long-term capital gain or loss with respect to any API in the year.

(B) *Determination of A's API One Year and Three Year Disposition Amounts.* Under paragraph (a)(4)(i) of this section, A's API One Year Disposition Amount is $400. This amount is the sum of A's $300 of long-term capital gain on A's disposition of the Distributed API Property and A's $100 of long-term capital gain on the disposition of the API. Under paragraph (a)(4)(ii) of this section, A's Three Year Disposition Amount is $100, which is the amount of long-term capital gain that A recognized upon disposition of the API held for more than three years. Under paragraph (a)(2) of this section, A's One Year Gain Amount is $400 and A's Three Year Gain Amount is $100.

(C) *Determination of A's Recharacterization Amount.* Under paragraph (a)(1) of this section, A's Recharacterization Amount is $300, which is the difference between A's One Year Gain Amount and Three Year Gain Amount.

(iii) *Example 3: Determination of One Year Gain Amount, Three Year Gain Amount, and Recharacterization Amount*—(A) *Facts.* A holds an API in each of PRS1 and PRS2. With respect to PRS1, A's API One Year Distributive Share Amount is $100 and A's API Three Year Distributive Share Amount is ($200). With respect to PRS2, A's API One Year Distributive Share Amount is $600 and A's API Three Year Distributive Share Amount is $300. During the taxable year, A also has an API One Year Disposition Amount of $200 of gain. A has no other items of long-term capital gain or loss with respect to an API for the taxable year.

(B) *Determination of A's One Year Gain Amount.* Under paragraph (a)(2) of this section, A's One Year Gain Amount is $900, which is an amount equal to A's $100 API One Year Distributive Share Gain from PRS1 and A's $600 API One Year Distributive Share from PRS2 (a combined net API One Year Distributive Share Amount of $700) plus A's $200 API One Year Disposition Amount.

(C) *Determination of A's Three Year Gain Amount.* Under paragraph (a)(2) of this section, A's Three Year Gain Amount is $100, which is equal to A's combined net API Three Year Distributive Share Amount for the taxable year

(A's $200 API Three Year Distributive Share Amount loss from PRS1 plus A's API Three Year Distributive Share Amount Gain of $300 from PRS2). A does not have an API Three Year Disposition Amount.

(D) *Determination of A's Recharacterization Amount*. Under paragraph (a)(1) of this section, A's Recharacterization Amount is $800. (A's One Year Gain Amount of $900 less A's Three Year Gain Amount of $100.)

(2) *Special rules examples*. The principles of paragraph (b) of this section are illustrated by the following examples.

(i) *Example 1: Lookthrough Rule*. On July 1, 2021, A and B form partnership PRS. At the time of PRS's formation, A agrees to provide substantial services to PRS in exchange for a 20% profits interest in PRS, and B, a partner that is an Unrelated Non-Service Partner, contributes $1 million in exchange for an interest in PRS and PRS immediately uses the capital to purchase marketable securities. On July 1, 2023, C, another Unrelated Non-Service Partner becomes legally obligated to contribute capital to PRS ($75 million) for the purposes of investing in and developing Specified Assets and is admitted into PRS. On July 3, 2023, and after C makes a contribution of $75 million, PRS uses this capital to acquire stock in portfolio company Z. On July 1, 2025, when Z has a value of $500 million and the value of the marketable securities is $2 million, A sells its API in PRS for $85.2 million. As a result of this sale, the Lookthrough Rule applies because B's contribution was non-substantial under paragraph (b)(9)(i)(A)(*1*) of this section. Therefore, A includes $85.2 million in its API One Year Disposition Amount and under paragraph (b)(9)(ii)(B) of this section, $200,000 (20% share of $1 million gain in marketable securities) in its API Three Year Disposition Amount. Accordingly, under paragraph (a)(1) of this section, A's Recharacterization Amount is $85 million.

(ii) *Example 2: Installment sale gain*. On December 22, 2021, A disposed of A's API in an installment sale. At the time of the disposition, A had held its API for two years. A received a payment with respect to the installment sale during A's 2022 taxable year causing A to recognize $200 of long-term capital gain. The $200 long-term capital gain recognized in 2022 is subject to section 1061 because it is recognized after December 31, 2017. Accordingly, the $200 of long-term capital gain recognized by A in 2022 is included in A's API One Year Disposition Amount. The $200 of long-term capital gain is not in A's API Three Year Disposition Amount because the API was not held for more than three years at the time of its disposition.

(iii) *Example 3: REIT capital gain dividend*. During the taxable year, A holds an API in PRS. PRS holds an interest in REIT. During the taxable year, REIT distributes a $1,000 capital gain dividend to PRS of which 50% is allocable to A's API. Part of the capital gain dividend for the year results from section 1231 gain. In accordance with § 1.1061–6(c)(1)(i), REIT discloses to PRS the One Year Amounts Disclosure of $400, which is the $1000 capital gain dividend reduced by the $600 of section 1231 capital gain dividend included in that amount. Part of the One Year Amounts Disclosure for the year results from gain from property held for three years or less. In accordance with § 1.1061–6(c)(1)(ii), REIT also discloses the Three Year Amounts Disclosure of $150, which is the $400 One Year Amounts Disclosure reduced by the $250 of gain attributable to property held for three years or less. PRS includes a $200 gain in determining A's API One Year Distributive Share Amount and a $75 gain in determining A's API Three Year Distributive Share Amount. See paragraphs (b)(5)(i) and (ii) of this section.

(d) *Applicability date*. The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

[T.D. 9945, 86 FR 5480, Jan. 19, 2021]

§ 1.1061–5 Section 1061(d) transfers to related persons.

(a) *In general*. If an Owner Taxpayer transfers any API or Distributed API Property, directly or indirectly, to a Section 1061(d) Related Person (as defined in paragraph (e) of this section), the Owner Taxpayer must include in gross income as short-term capital gain, an amount equal to—

(1) The short-term capital gain recognized upon the API transfer without regard to this paragraph (a); and

(2) The lesser of—

(i) The amount of net long-term capital gain recognized by the Owner Taxpayer upon the transfer of such interest; or

(ii) The amount treated as short-term capital gain under paragraph (c) of this section (Section 1061(d) Recharacterization Amount).

(b) *Transfer*. For purposes of this section, the term *transfer* means a sale or exchange in which gain is recognized by the Owner Taxpayer under chapter 1 of the Internal Revenue Code.

(c) *Section 1061(d) Recharacterization Amount*. To the extent an Owner Taxpayer recognizes long-term capital gain upon a transfer of an API to a Section 1061(d) Related Person, the Owner Taxpayer's Section 1061(d) Recharacterization Amount is the amount of net long-term capital gain (excluding amounts not taken into account for purposes of section 1061 under § 1.1061–4(b)(7)) from assets held for three years or less that would have been allocated to the Owner Taxpayer (to the extent attributable to the transferred API) by the partnership if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the Owner Taxpayer's transfer of the API. If only a portion of an Owner Taxpayer's API is transferred, this paragraph (c) shall apply with respect to the portion of gain attributable to the transferred interest.

(d) *Special rules*. For purposes of this section, the following rules are applicable.

(1) An Owner Taxpayer will be treated as transferring the Owner Taxpayer's share of any Indirect API or Distributed API Property if the Indirect API or Distributed API Property is transferred by the API Holder to a person that is a Section 1061(d) Related Person with respect to the Owner Taxpayer.

(2) The rules set forth in paragraphs (a), (b), and (c) of this section apply upon the transfer of a Passthrough Interest issued by an S corporation or PFIC to the extent the Passthrough Interest is treated as an API.

(e) *Section 1061(d) Related Person*. For purposes of this section, the term Section 1061(d) Related Person means—

(1) A person that is a member of the taxpayer's family within the meaning of section 318(a)(1);

(2) A person that performed a service within the current calendar year or the preceding three calendar years in a Relevant ATB to the API transferred by taxpayer; or

(3) A Passthrough Entity to the extent that a person described in paragraph (e)(1) or (2) of this section owns an interest, directly or indirectly.

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

(1) *Example 1: Transfer to child by gift*. A, an individual, performs services in an ATB and has held an API in connection with those services for 10 years. The API has a fair market value of $1,000 and a tax basis of $0, and no debt is associated with the API. A transfers all of the API to A's daughter as a gift. A's daughter is a section 1061(d) Related Person but A's gift is not a transfer as described in paragraph (b) of this section thus section 1061(d) does not apply to A's gift. However, the API remains an API in the hands of A's daughter under § 1.1061–2(a)(1)(i).

(2) *Example 2: Transfer of an API to a partnership owned by Section 1061(d) Related Persons*—(i) *Facts*. A, B, and C are equal partners in GP, a partnership. GP holds only one asset, an API in PRS1 which is an Indirect API as to each A, B, and C. A, B, and C each provides services in the ATB in connection with which GP was transferred its API in PRS1. A and B contribute their interests in GP to PRS2 in a Section 721(a) exchange for interests in PRS2.

(ii) *Application of section 1061(d)*. Because the contribution by A and B of

their interest in GP to PRS2 is an exchange in which no gain is recognized by either A or B, the contribution is not a transfer as described in paragraph (b) of this section thus section 1061(d) does not apply to A and B's contribution. However, the API remains an API in the hands of PRS2 under § 1.1061–2(a)(1)(i).

(3) *Example 3: Transfer of an API to a Section 1061(d) Related Person.* A holds an API in GP, a partnership which A has owned for four years. A transfers the API to a Section 1061(d) Related Person described in paragraph (e) of this section in exchange for $100 of cash, resulting in A recognizing long-term capital gain of $100. Because this is a transfer described in paragraph (b) of this section, section 1061(d) applies to the transfer of A's API and A must determine its Section 1061(d) Recharacterization Amount under paragraph (c) of this section. If, immediately prior to A's transfer of the API, the partnership had sold all of its assets in a fully taxable transaction for cash equal of the fair market value of the assets, A's share of the net long-term capital gain (excluding amounts not taken into account for purposes of section 1061 under § 1.1061–4(b)(7)) from assets held for three years or less would have been $120. Thus, A's Section 1061(d) Recharacterization Amount is $120. As a result, A's $100 long-term capital gain is re-characterized as short-term capital gain under paragraph (a) of this section. The API remains an API in the hands of the Section 1061(d) Related Person under § 1.1061–2(a)(1)(i).

(g) *Applicability date.* The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

[T.D. 9945, 86 FR 5480, Jan. 19, 2021]

§ 1.1061–6 Reporting rules.

(a) *Owner Taxpayer filing requirements*–(1) *In general.* An Owner Taxpayer must file such information with the IRS as the Commissioner of Internal Revenue or the Commissioner's delegate (Commissioner) may require in forms, instructions, or other guidance as is necessary for the Commissioner to determine that the Owner Taxpayer has properly complied with section 1061 and the Section 1061 Regulations. If an Owner Taxpayer requires information from a Passthrough Entity to determine the Capital Interest Disposition Amount or the Section 1061(d) Recharacterization Amount, the Owner Taxpayer must request such information from that entity.

(2) *Failure to obtain information.* Paragraph (b)(1) of this section requires certain Passthrough Entities to furnish an Owner Taxpayer with certain amounts necessary to determine its Recharacterization Amount and meet its reporting requirements under paragraph (a)(1) of this section. To the extent that an Owner Taxpayer is not furnished the information required to be furnished under paragraph (b)(1) of this section in such time and in such manner as required by the Commissioner and the Owner Taxpayer is not otherwise able to substantiate all or a part of these amounts to the satisfaction of the Commissioner, then if the information with respect to the determination of the—

(i) API One Year Distributive Share Amount under § 1.1061–4(a)(3)(i) is not furnished, the API One Year Distributive Share Amount will not be reduced by—

(A) Amounts not taken into account for purposes of section 1061 under § 1.1061–4(b)(7); or

(B) Capital Interest Gains and Losses as determined under § 1.1061–3(c)(2).

(ii) API Three Year Distributive Share Amount determined under § 1.1061–4(a)(3)(ii) is not furnished, all items included in the API One Year Distributive Share Amount are treated as items that would not be treated as long-term capital gain or loss, if three years is substituted for one year in paragraphs (3) and (4) of section 1222.

(b) *Passthrough Entity filing requirements and reporting*—(1) *Requirement to file information with the IRS and to furnish information to API Holder.* A Passthrough Entity must file such information with the IRS as the Commissioner

may require in forms, instructions, or other guidance as is necessary for the Commissioner to determine that it and its partners have complied with section 1061 and the Section 1061 Regulations. A Passthrough Entity that has issued an API must furnish to the API Holder, including an Owner Taxpayer, such information at such time and in such manner as the Commissioner may require in forms, instructions, or other guidance as is necessary to determine the One Year Gain Amount and the Three Year Gain Amount with respect to an Owner Taxpayer that directly or indirectly holds the API. A Passthrough Entity that has furnished information to the API Holder must file such information with the IRS, at such time and in such manner as the Commissioner may require in forms, instructions, or other guidance. This information includes:

(i) The API One Year Distributive Share Amount and the API Three Year Distributive Share Amount (as determined under § 1.1061–4);

(ii) Capital gains and losses allocated to the API Holder that are excluded from section 1061 under § 1.1061–4(b)(7);

(iii) Capital Interest Gains and Losses allocated to the API Holder (as determined under § 1.1061–3(c)); and

(iv) In the case of a disposition by an API Holder of an interest in the Passthrough Entity during the taxable year, upon the request of an API Holder, any information required by the API Holder to properly take the disposition into account under section 1061, including—

(A) Information necessary to apply the Lookthrough Rule and to determine the API Holder's Capital Interest Disposition Amount; and

(B) Information necessary to determine an Owner Taxpayer's Section 1061(d) Recharacterization Amount.

(2) *Requirement to request, furnish, and file information in tiered structures*—(i) *Requirement to request information.* If a Passthrough Entity requires information to meet its reporting and filing requirements under this section (in addition to any information required to be furnished to the Passthrough Entity under paragraph (b)(1) of this section) from a lower-tier entity in which it holds an interest, the Passthrough Entity must request such information from that entity.

(ii) *Requirement to furnish and file information.* If information is requested of a Passthrough Entity under paragraph (b)(2)(i) of this section, the Passthrough Entity must furnish the requested information to the person making the request but only to the extent the information is necessary for the requesting Passthrough Entity to meet its reporting and filing requirements under this section or is required by the Commissioner in forms, instructions, or other guidance. If the person requesting the information is an API Holder in the Passthrough Entity, the information is furnished under paragraph (b)(1) of this section. If the Passthrough Entity requesting the information is not an API Holder, the Passthrough Entity must furnish the information to the requesting Passthrough Entity as required by the Commissioner in forms, instructions, or other guidance.

(iii) *Timing of requesting and furnishing information*—(A) *Requesting information.* A Passthrough Entity described in paragraph (b)(2)(i) of this section must request information under paragraph (b)(2)(i) of this section by the later of the 30th day after the close of the taxable year to which the information request relates or 14 days after the date of a request for information from an upper-tier Passthrough Entity.

(B) *Furnishing information*—(*1*) *In general.* Except as provided in paragraph (b)(2)(iii)(B)(*2*) of this section, requested information must be furnished by the date on which the entity is required to furnish information under section 6031(b) or under section 6037(b), as applicable.

(*2*) *Late requests.* Information with respect to a taxable year that is requested by an upper-tier Passthrough Entity after the date that is 14 days prior to the due date for a lower-tier Passthrough Entity to furnish and file information under section 6031(b) or section 6037(b), as applicable, must be furnished and filed in the time and manner prescribed by forms, instructions and other guidance.

(iv) *Manner of requesting information.* Information may be requested electronically or in any manner that is agreed to by the parties.

(v) *Recordkeeping requirement.* Any Passthrough Entity receiving a request for information must retain a copy of the request and the date received in its books and records.

(vi) *Passthrough Entity is not furnished information to meet its reporting obligations under paragraph (b)(1) of this section.* If an upper-tier Passthrough Entity holds an interest in a lower-tier Passthrough Entity and it is not furnished the information described in paragraph (b)(1) of this section, or, alternatively, if it has not been furnished information after having properly requested the information under this paragraph (b)(2), the upper-tier Passthrough Entity must take actions to otherwise determine and substantiate the missing information. To the extent that the upper-tier Passthrough Entity is not able to otherwise substantiate and determine the missing information to the satisfaction of the Commissioner, the upper-tier Passthrough Entity must treat these amounts as provided under paragraph (a)(2) of this section. The upper-tier Passthrough Entity must provide notice to the API Holder and the IRS regarding the application of this paragraph (b)(2) to the information being reported as required in forms, instructions, and other guidance.

(vii) *Filing requirements.* Both the Passthrough Entity requesting the information and the Passthrough Entity furnishing the information must file all information with the IRS as the Commissioner may require in forms, instructions, or other guidance.

(viii) *Penalties.* In addition to the requirement in section 1061(e) that the Secretary shall require reporting (at the time and in the manner prescribed by the Secretary) as is necessary to carry out the purposes of this section, the information required to be furnished under this paragraph (b) is also required to be furnished under sections 6031(b) and 6037(b). Failure to report as required under this paragraph (b) will be subject to penalties under section 6722.

(c) *Regulated investment company (RIC) and real estate investment trust (REIT) reporting*—(1) *Section 1061 disclosures.* A RIC or REIT that reports or designates a dividend, or part thereof, as a capital gain dividend, may, in addition to the information otherwise required to be furnished to a shareholder, disclose two amounts for purposes of section 1061—

(i) *One Year Amounts Disclosure.* The *One Year Amounts Disclosure* of a RIC or REIT is a disclosure by the RIC or REIT of an amount that is attributable to a computation of the RIC's or REIT's net capital gain excluding capital gain and capital loss not taken into account for purposes of section 1061 under §1.1061–4(b)(7). The aggregate amounts provided in the One Year Amounts Disclosures with respect to a taxable year of a RIC or REIT must equal the lesser of the RIC's or REIT's net capital gain, excluding any capital gains and capital losses not taken into account for purposes of section 1061 under §1.1061–4(b)(7), for the taxable year or the RIC's or REIT's aggregate capital gain dividends for the taxable year.

(ii) *Three Year Amounts Disclosure.* The *Three Year Amounts Disclosure* of a RIC or REIT is a disclosure by the RIC or REIT of an amount that is attributable to a computation of the RIC's or REIT's One Year Amounts Disclosure substituting ''three years'' for ''one year'' in applying section 1222. The aggregate amounts provided in the Three Year Amounts Disclosures with respect to a taxable year of a RIC or REIT must equal the lesser of the aggregate amounts provided in the RIC's or REIT's One Year Amounts Disclosures substituting ''three years'' for ''one year'' in applying section 1222 for the taxable year or the RIC's or REIT's aggregate capital gain dividends for the taxable year.

(2) *Pro rata disclosures.* The One Year Amounts Disclosure and Three Year Amounts Disclosure made to each shareholder of a RIC or REIT must be proportionate to the share of capital gain dividends reported or designated to that shareholder for the taxable year.

(3) *Report to shareholders.* A RIC or REIT that provides the section 1061 disclosures described in paragraphs (c)(1)(i) and (ii) of this section must provide those section 1061 disclosures in writing to its shareholders with the statement described in section 852(b)(3)(C)(i) or the notice described in section 857(b)(3)(B) in which the capital gain dividend is reported or designated.

(d) *Qualified electing fund (QEF) reporting.* A passive foreign investment company with respect to which the shareholder has a QEF election (as described in section 1295(a)) in effect for the taxable year that determines net capital gain as provided in § 1.1293–1(a)(2)(i)(A), as limited by section 1293(e)(2), may provide some or all of the information listed in paragraph (b)(1) of this section (and any other relevant information) to its shareholders to enable API Holders to determine the amount of their inclusion under section 1293(a)(1) that would be included in the API One Year Distributive Share Amounts and API Three Year Distributive Share Amounts. To the extent that such information is not provided, paragraph (a)(2) of this section will apply except that Owner Taxpayers are not permitted to separately substantiate the information. An API Holder who receives the additional information described in this paragraph (d) must retain such information as required by § 1.1295–1(f)(2)(ii).

(e) *Applicability date.* The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

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CHANGES TO EFFECTUATE F.C.C. POLICY

§ 1.1071–1 Gain from sale or exchange to effectuate policies of Federal Communications Commission.

(a)(1) At the election of the taxpayer, section 1071 postpones the recognition of the gain upon the sale or exchange of property if the Federal Communications Commission grants the taxpayer a certificate with respect to the ownership and control of radio broadcasting stations which is in accordance with subparagraph (2) of this paragraph. Any taxpayer desiring to obtain the benefits of section 1071 shall file such certificate with the Commissioner of Internal Revenue, or the district director for the internal revenue district in which the income tax return of the taxpayer is required to be filed.

(2)(i) In the case of a sale or exchange before January 1, 1958, the certificate from the Federal Communications Commission must clearly identify the property and show that the sale or exchange is necessary or appropriate to effectuate the policies of such Commission with respect to the ownership and control of radio broadcasting stations.

(ii) In the case of a sale or exchange after December 31, 1957, the certificate from the Federal Communications Commission must clearly identify the property and show that the sale or exchange is necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, such Commission with respect to the ownership and control of radio broadcasting stations.

(3) The certificate shall be accompanied by a detailed statement showing the kind of property, the date of acquisition, the cost or other basis of the property, the date of sale or exchange, the name and address of the transferee, and the amount of money and the fair market value of the property other than money received upon such sale or exchange.

(b) Section 1071 applies only in the case of a sale or exchange made necessary by reason of the Federal Communications Commission's policies as to ownership or control of radio facilities. Section 1071 does not apply in the case of a sale or exchange made necessary as a result of other matters, such as the operation of a broadcasting station in a manner determined by the Commission to be not in the public interest or in violation of Federal or State law.

(c) An election to have the benefits of section 1071 shall be made in the manner prescribed in § 1.1071–4.

(d) For purposes of section 1071, the term *radio broadcasting* includes telecasting.

§ 1.1071–2 Nature and effect of election.

(a) *Alternative elections*. (1) A taxpayer entitled to the benefits of section 1071 in respect of a sale or exchange of property may elect—

(i) To treat such sale or exchange as an involuntary conversion under the provisions of section 1033; or

(ii) To treat such sale or exchange as an involuntary conversion under the provisions of section 1033, and in addition elect to reduce the basis of property, in accordance with the regulations prescribed in § 1.1071–3, by all or part of the gain that would otherwise be recognized under section 1033; or

(iii) To reduce the basis of property, in accordance with the regulations prescribed in § 1.1071–3, by all or part of the gain realized upon the sale or exchange.

(2) The effect of the provisions of subparagraph (1) of this paragraph is, in general, to grant the taxpayer an election to treat the proceeds of the sale or exchange as the proceeds of an involuntary conversion subject to the provisions of section 1033, and a further election to reduce the basis of certain property owned by the taxpayer by the amount of the gain realized upon the sale or exchange to the extent of that portion of the proceeds which is not treated as the proceeds of an involuntary conversion.

(3) An election in respect to a sale or exchange under section 1071 shall be irrevocable and binding for the taxable year in which the sale or exchange takes place and for all subsequent taxable years.

(b) *Application of section 1033*. (1) If the taxpayer elects, under either paragraph (a)(1) (i) or (ii) of this section, to treat the sale or exchange as an involuntary conversion, the provisions of section 1033, as modified by section 1071, together with the regulations prescribed under such sections, shall be applicable in determining the amount of recognized gain and the basis of property required as a result of such sale or exchange. For the purposes of section 1071 and the regulations thereunder, stock of a corporation operating a radio broadcasting station shall be treated as property similar or related in service or use to the property sold or exchanged. Securities of such a corporation other than stock, or securities of a corporation not operating a radio broadcasting station, do not constitute property similar or related in service or use to the property sold or exchanged. If the taxpayer exercises the election referred to in paragraph (a)(1)(i) of this section, the gain realized upon such sale or exchange shall be recognized to the extent of that part of the money received upon the sale or exchange which is not expended in the manner prescribed in section 1033 and the regulations thereunder. If, however, the taxpayer exercises the elections referred to in paragraph (a)(1)(ii) of this section, the amount of the gain which would be recognized, determined in the same manner as in the case of an election under paragraph (a)(1)(i) of this section, shall not be recognized but shall be applied to reduce the basis of property, remaining in the hands of the taxpayer after such sale or exchange or acquired by him during the same taxable year, which is of a character subject to the allowance for depreciation under section 167. Such reduction of basis shall be made in accordance with and under the conditions prescribed by § 1.1071–3.

(2) In the application of section 1033 to determine the recognized gain and the basis of property acquired as a result of a sale or exchange pursuant to an election under paragraph (a)(1) (i) or (ii) of this section, the entire amount of the proceeds of such sale or exchange shall be taken into account.

(c) *Example*. The application of the provisions of section 1071 may be illustrated by the following example:

Example: A, who makes his return on a calendar year basis, sold in 1954, for $100,000 cash, stock of X Corporation, which operates a radio broadcasting station. A's basis of this stock was $75,000. The sale was certified by the Federal Communications Commission as provided in section 1071. Soon after, in the same taxable year, A used $50,000 of the proceeds of the sale to purchase stock in Y Corporation, which operates a radio broadcasting station. A elected in his 1954 return to treat such sale and purchase as an involuntary conversion subject to the provisions

of section 1033. He also elected at the same time to reduce the basis of depreciable property by the amount of the gain that otherwise would be recognized under the provisions of section 1033, as made applicable by section 1071. The sale results in a recognized gain of $25,000 under section 1033. However, this gain is not recognized in this case because the taxpayer elected to reduce the basis of other property by the amount of the gain. This may be shown as follows:

(1) Sale price of X Corporation stock	$100,000
Basis for gain or loss	75,000
Gain realized	25,000
Proceeds of sale	100,000
Amount expended to replace property sold	50,000
Amount not expended in manner prescribed in section 1033	50,000
Realized gain, recognized under section 1033 (not to exceed the unexpended portion of proceeds of sale)	25,000
Less: Amount applied as a reduction of basis of depreciable property	25,000
Recognized gain for tax purposes	None

(2) The basis of Y Corporation stock in the hands of A is $50,000, computed in accordance with section 1033 and the regulations prescribed under that section. The $50,000 basis is computed as follows:

Basis of property sold (converted)	$75,000
Less: Amount of proceeds not expended	50,000
Balance	25,000
Plus amount of gain recognized under section 1033	25,000
Basis of Y Corporation stock in A's hands	50,000

§ 1.1071–3 Reduction of basis of property pursuant to election under section 1071.

(a) *General rule.* (1) In addition to the adjustments provided in section 1016 and other applicable provisions of chapter 1 of the Code which adjustments are required to be made with respect to the cost or other basis of property, a further adjustment shall be made in the amount of the unrecognized gain under section 1071, if the taxpayer so elects. Such further adjustment shall be made only with respect to the cost or other basis of property which is of a character subject to the allowance for depreciation under section 167 (whether or not used in connection with a broadcasting business), and which remains in the hands of the taxpayer immediately after the sale or exchange in respect of which the election is made, or which is acquired by the taxpayer in the same taxable year in which such sale or exchange occurs. If the property is in the hands of the taxpayer immediately after the sale or exchange, the time of reduction of the basis is the date of the sale or exchange; in all other cases the time of reduction of the basis is the date of acquisition.

(2) The reduction of basis under section 1071 in the amount of the unrecognized gain shall be made in respect of the cost or other basis, as of the time prescribed, of all units of property of the specified character. The cost or other basis of each unit shall be decreased in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) of such unit bears to the aggregate of such adjusted bases of all units of such property, but the amount of the decrease shall not be more than the amount of such adjusted basis. If in the application of such rule the adjusted basis of any unit is reduced to zero, the process shall be repeated to reduce the adjusted basis of the remaining units of property by the portion of the unrecognized gain which is not absorbed in the first application of the rule. For such purpose the *adjusted basis* of the remaining units shall be the adjusted basis for determining gain reduced by the amount of the adjustment previously made under this section. The process shall be repeated until the entire amount of the unrecognized gain has been absorbed.

(3) The application of the provisions of this section may be illustrated by the following example:

Example: Using the facts given in the example set forth in §1.1071–2(c), except that the taxpayer elects to reduce the basis of depreciable property in accordance with paragraph (a)(1)(iii) of §1.1071–2, the computation may be illustrated as follows:

Sale price of X Corporation stock	$100,000
Basis for gain or loss	75,000
Realized gain (recognized except for the election under §1.1071–1)	$25,000
Adjusted basis of other depreciable property in hands of A immediately after sale:	
Building	80,000
Transmitter	16,000

Fixtures	4,000
Total	100,000
Computation of reduction:	
Building (80,000/100,000) × $25,000 (gain)	20,000
Transmitter (16,000/100,000) × $25,000	4,000
Fixtures (4,000/100,000) × $25,000	1,000
Total reduction	25,000
New basis of assets:	
Building ($80,000 minus $20,000)	60,000
Transmitter ($16,000 minus $4,000)	12,000
Fixtures ($4,000 minus $1,000)	3,000
Total adjusted basis after reduction under section 1071	75,000
Realized gain upon sale of X Corporation stock	25,000
Less: Amount applied as a reduction to basis of depreciable property	25,000
Recognized gain for tax purposes	None

(b) *Special cases*. With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property of the class specified in section 1071 and this section adjusted in a manner different from the general rule set forth in paragraph (a) of this section. Variations from such general rule may, for example, involve adjusting the basis of only certain units of such property. The request for variations from such general rule should be filed by the taxpayer with his return for the taxable year in which he elects to have the basis of property reduced under section 1071. Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 7121.

§ 1.1071–4 Manner of election.

(a) An election under the provisions of section 1071 shall be in the form of a written statement and shall be executed and filed in duplicate. Such statement shall be signed by the taxpayer or his authorized representative. In the case of a corporation, the statement shall be signed with the corporate name, followed by the signature and title of an officer of the corporation empowered to sign for the corporation, and the corporate seal must be affixed. An election under section 1071 to reduce the basis of property and an election under such section to treat the sale or exchange as an involuntary conversion under section 1033 may be exercised independently of each other. An election under section 1071 must be filed with the return for the taxable year in which the sale or exchange occurs. Where practicable, the certificate of the Federal Communications Commission required by § 1.1071–1 should be filed with the election.

(b) If, in pursuance of an election to have the basis of its property adjusted under section 1071, the taxpayer desires to have such basis adjusted in any manner different from the general rule set forth in paragraph (a) of § 1.1071–3, the precise method (including allocation of amounts) should be set forth in detail on separate sheets accompanying the election. Consent by the Commissioner to any departure from such general rule shall be effected only by a closing agreement entered into under the provisions of section 7121.

EXCHANGES IN OBEDIENCE TO S.E.C. ORDERS

§ 1.1081–1 Terms used.

The following terms, when used in this section and §§ 1.1081–2 to 1.1083–1, inclusive, shall have the meanings assigned to them in section 1083: *Order of the Securities and Exchange Commission*; *registered holding company*; *holding company system*; *associate company*; *majority-owned subsidiary company*; *system group*; *nonexempt property*; and *stock or securities*. Any other term used in this section and §§ 1.1081–2 to 1.1083–1, inclusive, which is defined in the Internal Revenue Code of 1954, shall be given the respective definition contained in such Code.

§ 1.1081–2 Purpose and scope of exception.

(a) The general rule is that the entire amount of gain or loss from the sale or exchange of property is to be recognized (see section 1002) and that the entire amount received as a dividend is to be included in gross income. (See sections 61 and 301.) Exceptions to the general rule are provided elsewhere in

subchapters C and O, chapter 1 of the Code, one of which is that made by section 1081 with respect to exchanges, sales, and distributions specifically described in section 1081. Section 1081 provides the extent to which gain or loss is not to be recognized on (1) the receipt of a distribution described in section 1081(c)(2), or (2) an exchange or sale, or the receipt of a distribution, made in obedience to an order of the Securities and Exchange Commission, which is issued to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79k (b)). Section 331 provides that a distribution in liquidation of a corporation shall be treated as an exchange. Such distribution is to be treated as an exchange under the provisions of sections 1081 to 1083, inclusive. The order of the Securities and Exchange Commission must be one requiring or approving action which the Commission finds to be necessary or appropriate to effect a simplification or geographical integration of a particular public utility holding company system. For specific requirements with respect to an order of the Securities and Exchange Commission, see section 1081 (f).

(b) The requirements for nonrecognition of gain or loss as provided in section 1081 are precisely stated with respect to the following general types of transactions:

(1) The exchange that is provided for in section 1081 (a), in which stock or securities in a registered holding company or a majority-owned subsidiary company are exchanged for stock or securities.

(2) The exchange that is provided for in section 1081 (b), in which a registered holding company or an associate company of a registered holding company exchanges property for property.

(3) The distribution that is provided for in section 1081 (c)(1), in which stock or securities are distributed to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company, or the distribution that is provided for in section 1081 (c)(2), in which a corporation distributes to a shareholder, rights to acquire common stock in a second corporation.

(4) The transfer that is provided for in section 1081 (d), in which a corporation which is a member of a system group transfers property to another member of the same system group.

Certain rules with respect to the receipt of nonexempt property on an exchange described in section 1081 (a) are prescribed in section 1081 (e).

(c) These exceptions to the general rule are to be strictly construed. Unless both the purpose and the specific requirements of sections 1081 to 1083, inclusive, are clearly met, the recognition of gain or loss upon the exchange, sale, or distribution will not be postponed under those sections. Moreover, even though a taxable transaction occurs in connection or simultaneously with a realization of gain or loss to which nonrecognition is accorded, nevertheless, nonrecognition will not be accorded to such taxable transaction. In other words, the provisions of section 1081 do not extend in any case to gain or loss other than that realized from and directly attributable to a disposition of property as such, or the receipt of a corporate distribution as such, in an exchange, sale, or distribution specifically described in section 1081.

(d) The application of the provisions of part VI (section 1081 and following), subchapter O, chapter 1 of the Code, is intended to result only in postponing the recognition of gain or loss until a disposition of property is made which is not covered by such provisions, and, in the case of an exchange or sale subject to the provisions of section 1081 (b), in the reduction of basis of certain property. The provisions of section 1082 with respect to the continuation of basis and the reduction in basis are designed to effect these results. Although the time of recognition may be shifted, there must be a true reflection of income in all cases, and it is intended that the provisions of such part VI, shall not be construed or applied in such a way as to defeat this purpose.

§ 1.1081–3 Exchanges of stock or securities solely for stock or securities.

The exchange, without the recognition of gain or loss, that is provided for

in section 1081 (a) must be one in which stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary company are exchanged solely for stock or securities other than stock or securities which constitute nonexempt property. An exchange is not within the provisions of section 1081 (a) unless the stock or securities transferred and those received are stock or securities as defined by section 1083 (f). The stock or securities which may be received without the recognition of gain or loss are not limited to stock or securities in the corporation from which they are received. An exchange within the provisions of section 1081 (a) may be a transaction between the holder of stock or securities and the corporation which issued the stock or securities. Also the exchange may be made by a holder of stock or securities with an associate company (i.e., a corporation in the same holding company system with the issuing corporation) which is a registered holding company or a majority-owned subsidiary company. In either case, the nonrecognition provisions of section 1081 (a) apply only to the holder of the stock or securities. However, the transferee corporation must be acting in obedience to an order of the Securities and Exchange Commission directed to such corporation, if no gain or loss is to be recognized to the holder of the stock or securities who makes the exchange with such corporation. See also section 1081(b), in case the holder of the stock or securities is a registered holding company or an associate company of a registered holding company. An exchange is not within the provisions of section 1081(a) if it is within the provisions of section 1081(d), relating to transfers within a system group. For treatment when nonexempt property is received, see section 1081(e); for further limitations, see section 1081(f).

§ 1.1081–4 Exchanges of property for property by corporations.

(a) *Application of section 1081(b).* Section 1081(b) applies only to the transfers specified therein with respect to which section 1081(d) is inapplicable, and deals only with such transfers if gain is realized upon the sale or other disposition effected by such transfers. If loss is realized section 1081(b) is inapplicable and the application of other provisions of subtitle A of the Code must be determined. See section 1081(g). If section 1081(b) is applicable, the other provisions of subchapters C and O, chapter 1 of the Code, relating to the nonrecognition of gain are inapplicable, and the conditions under which, and the extent to which, the realized gain is not recognized are set forth in paragraphs (b), (c), (d), (e), and (f) of this section.

(b) *Nonrecognition of gain; no nonexempt proceeds.* No gain is recognized to a transferor corporation upon the sale or other disposition of property transferred by such transferor corporation in exchange solely for property other than nonexempt property, as defined in section 1083(e), but only if all of the following requirements are satisfied:

(1) The transferor corporation is, under the definition in section 1083 (b), a registered holding company or an associate company of a registered holding company;

(2) Such transfer is in obedience to an order of the Securities and Exchange Commission (as defined in section 1083 (a)) and such order satisfies the requirements of section 1081 (f);

(3) The transferor corporation has filed the required consent to the regulations under section 1082(a)(2) (see paragraph (g) of this section); and

(4) The entire amount of the gain, as determined under section 1001, can be applied in reduction of basis under section 1082(a)(2).

(c) *Nonrecognition of gain; nonexempt proceeds.* If the transaction would be within the provisions of paragraph (b) of this section if it were not for the fact that the property received in exchange consists in whole or in part of nonexempt property (as defined in section 1083 (e)), then no gain is recognized if such nonexempt property, or an amount equal to the fair market value of such nonexempt property at the time of the transfer.

(1) Is expended within the required 24-month period for property other than nonexempt property; or

(2) Is invested within the required 24-month period as a contribution to the

capital, or as paid-in surplus, of another corporation;

but only if the expenditure or investment is made

(3) In accordance with an order of the Securities and Exchange Commission (as defined in section 1083 (a)) which satisfies the requirements of section 1081 (f) and which recites that such expenditure or investment by the transferor corporation is necessary or appropriate to the integration or simplification of the holding company system of which the transferor corporation is a member; and

(4) The required consent, waiver, and bond have been executed and filed. See paragraphs (g) and (h) of this section.

(d) *Recognition of gain in part; insufficient expenditure or investment in case of nonexempt proceeds.* If the transaction would be within the provisions of paragraph (c) of this section if it were not for the fact that the amount expended or invested is less than the fair market value of the nonexempt property received in exchange, then the gain, if any, is recognized, but in an amount not in excess of the amount by which the fair market value of such nonexempt property at the time of the transfer exceeds the amount so expended and invested.

(e) *Items treated as expenditures for the purpose of paragraphs (c) and (d) of this section.* For the purposes of paragraphs (c) and (d) of this section, the following are treated as expenditures for property other than nonexempt property:

(1) A distribution in cancellation or redemption (except a distribution having the effect of a dividend) of the whole or a part of the transferor's own stock (not acquired on the transfer);

(2) A payment in complete or partial retirement or cancellation of securities representing indebtedness of the transferor or a complete or partial retirement or cancellation of such securities which is a part of the consideration for the transfer; and

(3) If, on the transfer, a liability of the transferor is assumed, or property of the transferor is transferred subject to a liability, the amount of such liability.

(f) *Recognition of gain in part; inability to reduce basis.* If the transaction would be within the provisions of paragraph (b) or (c) of this section, if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 1082(a)(2), then the gain, if any, is recognized, but in an amount not in excess of the amount which cannot be so applied in reduction of basis. If the transaction would be within the provisions of paragraph (d) of this section, if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 1082(a)(2), then the gain, if any, is recognized, but in an amount not in excess of the aggregate of—

(1) The amount of gain which would be recognized under paragraph (d) of this section if there were no inability to reduce basis under section 1082(a)(2); and

(2) The amount of gain which cannot be applied in reduction of basis under section 1082(a)(2).

(g) *Consent to regulations under section 1082(a)(2).* To be entitled to the benefits of the provisions of section 1081(b), a corporation must file with its return for the taxable year in which the transfer occurs a consent to have the basis of its property adjusted under section 1082(a)(2) (see §1.1082–3), in accordance with the provisions of the regulations in effect at the time of filing of the return for the taxable year in which the transfer occurs. Such consent shall be made on Form 982 in accordance with these regulations and instructions on the form or issued therewith.

(h) *Requirements with respect to expenditure or investment.* If the full amount of the expenditure or investment required for the application of paragraph (c) of this section has not been made by the close of the taxable year in which such transfer occurred, the taxpayer shall file with the return for such year an application for the benefit of the 24-month period for expenditure and investment, reciting the nature and time of the proposed expenditure or investment. When requested by the district director, the taxpayer shall execute and file (at such time and in such form) such waiver of the statute of limitations with respect to the assessment of deficiencies (for the taxable year of the transfer and for all succeeding taxable years in any of

which falls any part of the period beginning with the date of the transfer and ending 24 months thereafter) as the district director may specify, and such bond with such surety as the district director may require, in an amount not in excess of double the estimated maximum income tax which would be payable if the corporation does not make the required expenditure or investment within the required 24-month period.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6751, 29 FR 11356, Aug. 6, 1964; T.D. 7517, 42 FR 58935, Nov. 14, 1977]

§ 1.1081–5 Distribution solely of stock or securities.

(a) *In general*. If, without any surrender of his stock or securities as defined in section 1083(f), a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company receives stock or securities in such corporation or owned by such corporation, no gain to the shareholder will be recognized with respect to the stock or securities received by such shareholder which do not constitute nonexempt property, if the distribution to such shareholder is made by the distributing corporation in obedience to an order of the Securities and Exchange Commission directed to such corporation. A distribution is not within the provisions of section 1081(c)(1) if it is within the provisions of section 1081(d), relating to transfers within a system group. A distribution is also not within the provisions of section 1081(c)(1) if it involves a surrender by the shareholder of stock or securities or a transfer by the shareholder of property in exchange for the stock or securities received by the shareholder. For further limitations, see section 1081(f).

(b) *Special rule*. (1) If there is distributed to a shareholder in a corporation rights to acquire common stock in a second corporation, no gain to the shareholder from the receipt of the rights shall be recognized, but only if all the following requirements are met:

(i) The rights are received by the shareholder without the surrender by the shareholder of any stock in the distributing corporation,

(ii) Such distribution is in accordance with an arrangement forming a ground for an order of the Securities and Exchange Commission issued pursuant to section 3 of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79c) that the distributing corporation is exempt from any provision or provisions of such act, and

(iii) Before January 1, 1958, the distributing corporation disposes of all the common stock in the second corporation which it owns.

(2) The distributing corporation shall, as soon as practicable, notify the district director in whose district the corporation's income tax return and supporting data was filed (see paragraph (g) of § 1.1081–11), as to whether or not the requirement of subparagraph (1)(iii) of this paragraph has been met. If such requirement has not been met, the periods of limitation (sections 6501 and 6502) with respect to any deficiency, including interest and additions to the tax, resulting solely from the receipt of such rights to acquire stock, shall include one year immediately following the date of such notification; and assessment and collection shall be made notwithstanding any provisions of law or rule of law which would otherwise prevent such assessment and collection.

§ 1.1081–6 Transfers within system group.

(a) The nonrecognition of gain or loss provided for in section 1081(d)(1) is applicable to an exchange of property for other property (including money and other nonexempt property) between corporations which are all members of the same system group. The term *system group* is defined in section 1083 (d).

(b) Section 1081 (d)(1) also provides for nonrecognition of gain to a corporation which is a member of a system group if property (including money or other nonexempt property) is distributed to such corporation as a shareholder in a corporation which is a member of the same system group, without the surrender by such shareholder of stock or securities in the distributing corporation.

(c) As stated in § 1.1081–2, nonrecognition of gain or loss will not be accorded to a transaction not clearly provided for in part VI (section 1081 and following), subchapter O, chapter 1 of the

Code, even though such transaction occurs simultaneously or in connection with an exchange, sale, or distribution to which nonrecognition is specifically accorded. Therefore, nonrecognition will not be accorded to any gain or loss realized from the discharge, or the removal of the burden, of the pecuniary obligations of a member of a system group, even though such obligations are acquired upon a transfer or distribution specifically described in section 1081 (d)(1); but the fact that the acquisition of such obligations was upon a transfer or distribution specifically described in section 1081 (d)(1) will, because of the basis provisions of section 1082 (d), affect the cost to the member of such discharge or its equivalent. Thus, section 1081 (d)(1) does not provide for the nonrecognition of any gain or loss realized from the discharge of the indebtedness of a member of a system group as the result of the acquisition in exchange, sale, or distribution of its own bonds, notes, or other evidences of indebtedness which were acquired by another member of the same system group for a consideration less or more than the issuing price thereof (with proper adjustments for amortization of premiums or discounts).

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

Example: Suppose that the A Corporation and the B Corporation are both members of the same system group; that the A Corporation holds at a cost of $900 a bond issued by the B Corporation at par, $1,000; and that the A Corporation and the B Corporation enter into an exchange subject to the provisions of section 1081 (d)(1) in which the $1,000 bond of the B Corporation is transferred from the A Corporation to the B Corporation. The $900 basis reflecting the cost to the A Corporation which would have been the basis available to the B Corporation if the property transferred to it had been something other than its own securities (see § 1.1082–6) will, in this type of transaction, reflect the cost to the B Corporation of effecting a retirement of its own $1,000 bond. The $100 gain of the B Corporation reflected in the retirement will therefore be recognized.

(e) No exchange or distribution may be made without the recognition of gain or loss as provided for in section 1081 (d)(1), unless all the corporations which are parties to such exchange or distribution are acting in obedience to an order of the Securities and Exchange Commission. If an exchange or distribution is within the provisions of section 1081 (d)(1) and also may be considered to be within some other provisions of section 1081, it shall be considered that only the provisions of section 1081 (d)(1) apply and that the nonrecognition of gain or loss upon such exchange or distribution is by virtue of that section.

§ 1.1081–7 Sale of stock or securities received upon exchange by members of system group.

(a) Section 1081(d)(2) provides that to the extent that property received upon an exchange by corporations which are members of the same system group consists of stock or securities issued by the corporation from which such property was received, such stock or securities may, under certain specifically described circumstances, be sold to a party not a member of the system group, without the recognition of gain or loss to the selling corporation. The nonrecognition of gain or loss is limited, in the case of stock, to a sale of stock which is preferred as to both dividends and assets. The stock or securities must have been received upon an exchange with respect to which section 1081(d)(1) operated to prevent recognition of gain or loss to any party to the exchange. Nonrecognition of gain or loss upon the sale of such stock or securities is permitted only if the proceeds derived from the sale are applied in retirement or cancellation of stock or securities of the selling corporation which were outstanding at the time the exchange was made. It is also essential to nonrecognition of gain or loss upon the sale that both the sale of the stock or securities and the application of the proceeds derived therefrom be made in obedience to an order of the Securities and Exchange Commission. If any part of the proceeds derived from the sale is not applied in making the required retirement or cancellation of stock or securities and if the sale is otherwise within the provisions of section 1081 (d)(2), the gain resulting from the sale shall be recognized, but in an amount not in excess of the proceeds which are

not so applied. In any event, if the proceeds derived from the sale of the stock or securities exceed the fair market value of such stock or securities at the time of the exchange through which they were acquired by the selling corporation, the gain resulting from the sale is to be recognized to the extent of such excess. Section 1081 (d)(2) does not provide for the nonrecognition of any gain resulting from the retirement of bonds, notes, or other evidences of indebtedness for a consideration less than the issuing price thereof. Also, that section does not provide for the nonrecognition of gain or loss upon the sale of any stock or securities received upon a distribution or otherwise than upon an exchange.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example: The X Corporation and the Y Corporation, both of which make their income tax returns on a calendar year basis, are members of the same system group. As part of an exchange to which section 1081 (d)(1) is applicable the Y Corporation on June 1, 1954, issued to the X Corporation 1,000 shares of class A stock, preferred as to both dividends and assets. The fair market value of such stock at the time of issuance was $90,000 and its basis to the X Corporation was $75,000. On December 1, 1954, in obedience to an appropriate order of the Securities and Exchange Commission, the X Corporation sells all of such stock to the public for $100,000 and applies $95,000 of this amount to the retirement of its own bonds, which were outstanding on June 1, 1954. The remaining $5,000 is not used to retire any of the X Corporation's stock or securities. Of the total gain of $25,000 realized on the disposition of the Y Corporation stock, only $10,000 is recognized (the difference between the fair market value of the stock when acquired and the amount for which it was sold), since such amount is greater than the portion ($5,000) of the proceeds not applied to the retirement of the X Corporation's stock or securities. If in this example the stock acquired by the X Corporation had not been stock of the Y Corporation issued to the X Corporation or if it had been stock not preferred as to both dividends and assets, the full amount of the gain ($25,000) realized upon its disposition would have been recognized, regardless of what was done with the proceeds.

§ 1.1081–8 Exchanges in which money or other nonexempt property is received.

(a) Under section 1081(e)(1), if in any exchange (not within any of the provisions of section 1081(d)) in which stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary are exchanged for stock or securities as provided for in section 1081 (a), there is received by the taxpayer money or other nonexempt property (in addition to property permitted to be received without recognition of gain), then—

(1) The gain, if any, to the taxpayer is to be recognized in an amount not in excess of the sum of the money and the fair market value of the other nonexempt property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent.

(b) If money or other nonexempt property is received from a corporation in an exchange described in paragraph (a) of this section and if the distribution of such money or other nonexempt property by or on behalf of such corporation has the effect of the distribution of a taxable dividend, then, as provided in section 1081 (e)(2), there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) the remainder of the gain so recognized shall be taxed as a gain from the exchange of property.

§ 1.1081–9 Requirements with respect to order of Securities and Exchange Commission.

The term *order of the Securities and Exchange Commission* is defined in section 1083(a). In addition to the requirements specified in that definition, section 1081(f) provides that, except in the case of a distribution described in section 1081(c)(2), the provisions of section 1081 shall not apply to an exchange, expenditure, investment, distribution, or sale unless each of the following requirements is met:

(a) The order of the Securities and Exchange Commission must recite that

the exchange, expenditure, investment, distribution, or sale is necessary or appropriate to effectuate the provisions of section 11(b) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79k (b)).

(b) The order shall specify and itemize the stocks and securities and other property (including money) which are ordered to be acquired, transferred, received, or sold upon such exchange, acquisition, expenditure, distribution, or sale and, in the case of an investment, the investment to be made, so as clearly to identify such property.

(c) The exchange, acquisition, expenditure, investment, distribution, or sale shall be made in obedience to such order and shall be completed within the time prescribed in such order.

These requirements were not designed merely to simplify the administration of the provisions of section 1081, and they are not to be considered as pertaining only to administrative matters. Each one of the three requirements is essential and must be met if gain or loss is not to be recognized upon the transaction.

§ 1.1081–10 Nonapplication of other provisions of the Internal Revenue Code of 1954.

The effect of section 1081(g) is that an exchange, sale, or distribution which is within section 1081 shall, with respect to the nonrecognition of gain or loss and the determination of basis, be governed only by the provisions of part VI (section 1081 and following), subchapter O, chapter 1 of the Code, the purpose being to prevent overlapping of those provisions and other provisions of subtitle A of the Code. In other words, if by virtue of section 1081 any portion of a person's gain or loss on any particular exchange, sale, or distribution is not to be recognized, then the gain or loss of such person shall be nonrecognized only to the extent provided in section 1081, regardless of what the result might have been if part VI (section 1081 and following), subchapter O, chapter 1 of the Code, had not been enacted; and similarly, the basis in the hands of such person of the property received by him in such transaction shall be the basis provided by section 1082, regardless of what the basis of such property might have been under section 1011 if such part VI had not been enacted. On the other hand, if section 1081 does not provide for the nonrecognition of any portion of a person's gain or loss (whether or not such person is another party to the same transaction referred to above), then the gain or loss of such person shall be recognized or nonrecognized to the extent provided for by other provisions of subtitle A of the Code as if such part VI had not been enacted; and similarly, the basis in his hands of the property received by him in such transaction shall be the basis provided by other provisions of subtitle A of the Code as if such part VI had not been enacted.

§ 1.1081–11 Records to be kept and information to be filed with returns.

(a) *Distributions and exchanges; significant holders of stock or securities.* Every significant holder must include a statement entitled, ''STATEMENT PURSUANT TO §1.1081–11(a) BY [INSERT NAME AND TAXPAYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER], A SIGNIFICANT HOLDER,'' on or with such holder's income tax return for the taxable year in which the distribution or exchange occurs. If a significant holder is a controlled foreign corporation (within the meaning of section 957), each United States shareholder (within the meaning of section 951(b)) with respect thereto must include this statement on or with its return. The statement must include—

(1) The name and employer identification number (if any) of the corporation from which the stock, securities, or other property (including money) was received by such significant holder;

(2) The aggregate basis, determined immediately before the exchange, of any stock or securities transferred by the significant holder in the exchange, and the aggregate fair market value, determined immediately before the distribution or exchange, of the stock, securities or other property (including money) received by the significant holder in the distribution or exchange; and

(3) The date of the distribution or exchange.

(b) *Distributions and exchanges; corporations subject to Commission orders.* Each corporation which is a party to a distribution or exchange made pursuant to an order of the Commission must include on or with its income tax return for its taxable year in which the distribution or exchange takes place a statement entitled, ''STATEMENT PURSUANT TO §1.1081–11(b) BY [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER], A DISTRIBUTING OR EXCHANGING CORPORATION.'' If the distributing or exchanging corporation is a controlled foreign corporation (within the meaning of section 957), each United States shareholder (within the meaning of section 951(b)) with respect thereto must include this statement on or with its return. The statement must include—

(1) The date and control number of the Commission order, pursuant to which the distribution or exchange was made;

(2) The names and taxpayer identification numbers (if any) of the significant holders;

(3) The aggregate fair market value and basis, determined immediately before the distribution or exchange, of the stock, securities, or other property (including money) transferred in the distribution or exchange; and

(4) The date of the distribution or exchange.

(c) *Sales by members of system groups.* Each system group member must include a statement entitled, ''STATEMENT PURSUANT TO §1.1081–11(c) BY [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER], A SYSTEM GROUP MEMBER,'' on or with its income tax return for the taxable year in which the sale is made. If any system group member is a controlled foreign corporation (within the meaning of section 957), each United States shareholder (within the meaning of section 951(b)) with respect thereto must include this statement on or with its return. The statement must include—

(1) The dates and control numbers of all relevant Commission orders;

(2) The aggregate fair market value and basis, determined immediately before the sale, of all stock or securities sold; and

(3) The date of the sale.

(d) *Definitions.* (1) For purposes of this section, *Commission* means the Securities and Exchange Commission.

(2) For purposes of this section, *significant holder* means a person that receives stock or securities from a corporation (the distributing corporation) pursuant to an order of the Commission, if, immediately before the transaction, such person—

(i) In the case of stock—

(A) Owned at least five percent (by vote or value) of the total outstanding stock of the distributing corporation if the stock owned by such person is publicly traded, or

(B) Owned at least one percent (by vote or value) of the total outstanding stock of the distributing corporation if the stock owned by such person is not publicly traded; or

(ii) In the case of securities, owned securities of the distributing corporation with a basis of $1,000,000 or more.

(3) *Publicly traded stock* means stock that is listed on—

(i) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); or

(ii) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934 (15 U.S.C. 78o–3).

(4) For purposes of paragraph (b) of this section, exchange means exchange, expenditure, or investment.

(5) For purposes of paragraph (c) of this section, *system group member* means each corporation which is a member of a system group and which, pursuant to an order of the Commission, sells stock or securities received upon an exchange (pursuant to an order of the Commission) and applies the proceeds derived therefrom in retirement or cancellation of its own stock or securities.

(e) *Substantiation information.* Under §1.6001–1(e), taxpayers are required to retain their permanent records and make such records available to any authorized Internal Revenue Service officers and employees. In connection with the distribution or exchange described in this section, these records should

specifically include information regarding the amount, basis, and fair market value of all property distributed or exchanged, and relevant facts regarding any liabilities assumed or extinguished as part of such distribution or exchange.

(f) *Effective/applicability date.* This section applies to any taxable year beginning on or after May 30, 2006. However, taxpayers may apply this section to any original Federal income tax return (including any amended return filed on or before the due date (including extensions) of such original return) timely filed on or after May 30, 2006. For taxable years beginning before May 30, 2006, see § 1.1081–11 as contained in 26 CFR part 1 in effect on April 1, 2006.

[T.D. 9329, 72 FR 32803, June 14, 2007]

§ 1.1082–1 Basis for determining gain or loss.

(a) For determining the basis of property acquired in a taxable year beginning before January 1, 1942, in any manner described in section 372 of the Internal Revenue Code of 1939 prior to its amendment by the Revenue Act of 1942 (56 Stat. 798), see such section (before its amendment by such Act).

(b) If the property was acquired in a taxable year beginning after December 31, 1941, in any manner described in section 1082 (other than subsection (a)(2)), or section 372 (other than subsection (a)(2)) of the Internal Revenue Code of 1939 after its amendments, the basis shall be that prescribed in section 1082 with respect to such property. However, in the case of property acquired in a transaction described in section 1081(c)(2), this paragraph is applicable only if the property was acquired in a distribution made in a taxable year subject to the Internal Revenue Code of 1954.

(c) Section 1082 makes provisions with respect to the basis of property acquired in a transfer in connection with which the recognition of gain or loss is prohibited by the provisions of section 1081 with respect to the whole or any part of the property received. In general, and except as provided in § 1.1082–3, it is intended that the basis for determining gain or loss pertaining to the property prior to its transfer, as well as the basis for determining the amount of depreciation or depletion deductible and the amount of earnings or profits available for distribution, shall continue notwithstanding the nontaxable conversion of the asset in form or its change in ownership. The continuance of the basis may be reflected in a shift thereof from one asset to another in the hands of the same owner, or in its transfer with the property from one owner into the hands of another. See also § 1.1081–2.

§ 1.1082–2 Basis of property acquired upon exchanges under section 1081 (a) or (e).

(a) In the case of an exchange of stock or securities for stock or securities as described in section 1081 (a), if no part of the gain or loss upon such exchange was recognized under section 1081, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange.

(b) If, in an exchange of stock or securities as described in section 1081 (a), gain to the taxpayer was recognized under section 1081 (e) on account of the receipt of money, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized upon the exchange. If, upon such exchange, there were received by the taxpayer money and other nonexempt property (not permitted to be received without the recognition of gain), and gain from the transaction was recognized under section 1081 (e), the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of money received and increased by the amount of gain recognized, must be apportioned to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of such basis to the properties received, there must be assigned to the nonexempt property (other than money) an amount equivalent to its fair market value at the date of the exchange.

(c) Section 1081(e) provides that no loss may be recognized on an exchange of stock or securities for stock or securities as described in section 1081(a), although the taxpayer receives money or other nonexempt property from the transaction. However, the basis of the property (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be apportioned to the properties received, and for this purpose there must be allocated to the nonexempt property (other than money) an amount of such basis equivalent to the fair market value of such nonexempt property at the date of the exchange.

(d) Section 1082 (a) does not apply in ascertaining the basis of property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it. For the rule in such cases, see section 1082 (b).

(e) For purposes of this section, any reference to section 1081 shall be deemed to include a reference to corresponding provisions of prior internal revenue laws.

§ 1.1082–3 Reduction of basis of property by reason of gain not recognized under section 1081(b).

(a) *Introductory*. In addition to the adjustments provided in section 1016 and other applicable provisions of chapter 1 of the Code, and the regulations relating thereto, which are required to be made with respect to the cost or other basis of property, section 1082(a)(2) provides that a further adjustment shall be made in any case in which there shall have been a nonrecognition of gain under section 1081(b). Such further adjustment shall be made with respect to the basis of the property in the hands of the transferor immediately after the transfer and of the property acquired within 24 months after such transfer by an expenditure or investment to which section 1081(b) relates, and on account of which expenditure or investment gain is not recognized. If the property is in the hands of the transferor immediately after the transfer, the time of reduction is the day of the transfer; in all other cases the time of reduction is the date of acquisition. The effect of applying an amount in reduction of basis of property under section 1081 (b) is to reduce by such amount the basis for determining gain upon sale or other disposition, the basis for determining loss upon sale or other disposition, the basis for depreciation and for depletion, and any other amount which the Code prescribes shall be the same as any of such bases. For the purposes of the application of an amount in reduction of basis under section 1081(b), property is not considered as having a basis capable of reduction if—

(1) It is money, or

(2) If its adjusted basis for determining gain at the time the reduction is to be made is zero, or becomes zero at any time in the application of section 1081 (b).

(b) *General rule*. (1) Section 1082 (a)(2) sets forth seven categories of property, the basis of which for determining gain or loss shall be reduced in the order stated.

(2) If any of the property in the first category has a basis capable of reduction, the reduction must first be made before applying an amount in reduction of the basis of any property in the second or in a succeeding category, to each of which in turn a similar rule is applied.

(3) In the application of the rule to each category, the amount of the gain not recognized shall be applied to reduce the cost or other basis of all the property in the category as follows: The cost or other basis (at the time immediately after the transfer or, if the property is not then held but is thereafter acquired, at the time of such acquisition) of each unit of property in the first category shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis at such time for determining gain, determined without regard to this section) in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) at such time of each unit of property of the taxpayer in that category bears to the aggregate of the adjusted basis (for determining gain, computed without regard to this

section) at such time of all the property of the taxpayer in that category. When such adjusted basis of the property in the first category has been thus reduced to zero, a similar rule shall be applied, with respect to the portion of such gain which is unabsorbed in such reduction of the basis of the property in such category, in reducing the basis of the property in the second category. A similar rule with respect to the remaining unabsorbed gain shall be applied in reducing the basis of the property in the next succeeding category.

(c) *Special cases.* (1) With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property within a particular category specified in section 1082(a)(2) adjusted in a manner different from the general rule set forth in paragraph (b) of this section. Variations from such general rule may, for example, involve adjusting the basis of only certain units of the taxpayer's property within a given category. A request for variations from the general rule should be filed by the taxpayer with its income tax return for the taxable year in which the transfer of property has occurred.

(2) Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 7121. If no such agreement is entered into by the taxpayer and the Commissioner, then the consent filed on Form 982 shall (except as otherwise provided in this subparagraph) be deemed to be a consent to the application of such general rule, and such general rule shall apply in the determination of the basis of the taxpayer's property. If, however, the taxpayer specifically states on such form that it does not consent to the application of the general rule, then, in the absence of a closing agreement, the document filed shall not be deemed a consent within the meaning of section 1081(b)(4).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7517, 42 FR 58935, Nov. 14, 1977]

§ 1.1082–4 Basis of property acquired by corporation under section 1081(a), 1081(b), or 1081(e) as contribution of capital or surplus, or in consideration for its own stock or securities.

If, in connection with an exchange of stock or securities for stock or securities as described in section 1081(a), or an exchange of property for property as described in section 1081(b), or an exchange as described in section 1081(e), property is acquired by a corporation by the issuance of its stock or securities, the basis of such property shall be determined under section 1082(b). If the corporation issued its stock or securities as part or sole consideration for the property acquired, the basis of the property in the hands of the acquiring corporation is the basis (adjusted to the date of the exchange) which the property would have had in the hands of the transferor if the transfer had not been made, increased in the amount of gain or decreased in the amount of loss recognized under section 1081 to the transferor upon the transfer. If any property is acquired by a corporation from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property to the corporation is the basis (adjusted to the date of acquisition) of the property in the hands of the transferor.

§ 1.1082–5 Basis of property acquired by shareholder upon tax-free distribution under section 1081(c) (1) or (2).

(a) *Stock or securities.* If there was distributed to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company, stock or securities (other than stock or securities which are nonexempt property), and if by virtue of section 1081 (c)(1) no gain was recognized to the shareholder upon such distribution, then the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock or securities so distributed to the shareholder. The basis of the old shares and the stock or securities received upon the distribution shall be determined in accordance with the following rules:

(1) If the stock or securities received upon the distribution consist solely of

stock in the distributing corporation and the stock received is all of substantially the same character and preference as the stock in respect of which the distribution is made, the basis of each share will be the quotient of the cost or other basis of the old shares of stock divided by the total number of the old and the new shares.

(2) If the stock or securities received upon the distribution are in whole or in part stock in a corporation other than the distributing corporation, or are in whole or in part stock of a character or preference materially different from the stock in respect of which the distribution is made, or if the distribution consists in whole or in part of securities other than stock, the cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock or securities distributed in proportion, as nearly as may be, to the respective values of each class of stock or security, old and new, at the time of such distribution, and the basis of each share of stock or unit of security will be the quotient of the cost or other basis of the class of stock or security to which such share or unit belongs, divided by the number of shares or units in the class. Within the meaning of this subparagraph, stocks or securities in one corporation are different in class from stocks or securities in another corporation, and, in general, any material difference in character or preference or terms sufficient to distinguish one stock or security from another stock or security, so that different values may properly be assigned thereto, will constitute a difference in class.

(b) *Stock rights*. If there was distributed to a shareholder in a corporation rights to acquire common stock in a second corporation, and if by virtue of section 1081 (c)(2) no gain was recognized to the shareholder upon such distribution, then the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock rights so distributed to the shareholder. The basis of such stock and the stock rights received upon the distribution shall be determined in accordance with the following:

(1) The cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock rights distributed, in proportion to the respective values thereof at the time the rights are issued.

(2) The basis for determining gain or loss from the sale of a right, or from the sale of a share of stock in respect of which the distribution is made, will be the quotient of the cost or other basis, properly adjusted, assigned to the rights or the stock, divided, as the case may be, by the number of rights acquired or by the number of shares of such stock held.

(c) *Cross reference*. As to the basis of stock or securities distributed by one member of a system group to another member of the same system group, see § 1.1082–6.

§ 1.1082–6 Basis of property acquired under section 1081(d) in transactions between corporations of the same system group.

(a) If property was acquired by a corporation which is a member of a system group, from a corporation which is a member of the same system group, upon a transfer or distribution described in section 1081 (d)(1), then as a general rule the basis of such property in the hands of the acquiring corporation is the basis which such property would have had in the hands of the transferor if the transfer or distribution had not been made. Except as otherwise indicated in this section, this rule will apply equally to cases in which the consideration for the property acquired consists of stock or securities, money, and other property, or any of them, but it is contemplated that an ultimate true reflection of income will be obtained in all cases, notwithstanding any peculiarities in form which the various transactions may assume. See the example in § 1.1081–6.

(b) An exception to the general rule is provided for in case the property acquired consists of stock or securities issued by the corporation from which such stock or securities were received. If such stock or securities were the sole consideration for the property transferred to the corporation issuing such stock or securities, then the basis of

the stock or securities shall be (1) the same as the basis (adjusted to the time of the transfer) of the property transferred for such stock or securities, or (2) the fair market value of such stock or securities at the time of their receipt, whichever is the lower. If such stock or securities constituted only part consideration for the property transferred to the corporation issuing such stock or securities, then the basis shall be an amount which bears the same ratio to the basis of the property transferred as the fair market value of such stock or securities on their receipt bears to the total fair market value of the entire consideration received, except that the fair market value of such stock or securities at the time of their receipt shall be the basis therefor, if such value is lower than such amount.

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

Example 1. Suppose the A Corporation has property with an adjusted basis of $600,000 and, in an exchange in which section 1081 (d)(1) is applicable, transfers such property to the B Corporation in exchange for a total consideration of $1,000,000, consisting of (1) cash in the amount of $100,000, (2) tangible property having a fair market value of $400,000 and an adjusted basis in the hands of the B Corporation of $300,000, and (3) stock or securities issued by the B Corporation with a par value and a fair market value as of the date of their receipt in the amount of $500,000. The basis to the B Corporation of the property received by it is $600,000, which is the adjusted basis of such property in the hands of the A Corporation. The basis to the A Corporation of the assets (other than cash) received by it is as follows: Tangible property, $300,000, the adjusted basis of such property to the B Corporation, the former owner; stock or securities issued by the B Corporation, $300,000, an amount equal to 550,000/1,000,000ths of $600,000.

Example 2. Suppose that in example (1) the property of the A Corporation transferred to the B Corporation had an adjusted basis of $1,100,000 instead of $600,000, and that all other factors in the example remain the same. In such case, the basis to the A Corporation of the stock or securities in the B Corporation is $500,000, which was the fair market value of such stock or securities at the time of their receipt by the A Corporation, because this amount is less than the amount established as 500,000/1,000,000ths of $1,100,000 or $550,000.

§ 1.1083–1 Definitions.

(a) *Order of the Securities and Exchange Commission.* (1) An order of the Securities and Exchange Commission as defined in section 1083(a) must be issued after May 28, 1938 (the date of the enactment of the Revenue Act of 1938 (52 Stat. 447)), and must be issued under the authority of section 11(b) or 11(e) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79k (b), (e)), to effectuate the provisions of section 11(b) of such Act. In all cases the order must become or have become final in accordance with law; i.e., it must be valid, outstanding, and not subject to further appeal. See further sections 1083(a) and 1081(f).

(2) Section 11 (b) of the Public Utility Holding Company Act of 1935 provides:

Sec. 11. *Simplification of holding company systems.* * * *

(b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938:

(1) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system: *Provided, however,* That the Commission shall permit a registered holding company to continue to control one or more additional integrated public-utility systems, if, after notice and opportunity for hearing, it finds that—

(A) Each of such additional systems cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of control by such holding company of such system;

(B) All of such additional systems are located in one State, or in adjoining States, or in a contiguous foreign country; and

(C) The continued combination of such systems under the control of such holding company is not so large (considering the state of the art and the area or region affected) as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation.

The Commission may permit as reasonably incidental, or economically necessary or appropriate to the operations of one or more integrated public-utility systems the retention of an interest in any business (other than the business of a public-utility company as such) which the Commission shall

find necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems.

(2) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company, or of any company whose principal business is that of a public-utility company. The Commission may by order revoke or modify any order previously made under this subsection, if, after notice and opportunity for hearing, it finds that the conditions upon which the order was predicated do not exist. Any order made under this subsection shall be subject to judicial review as provided in section 24.

(3) Section 11(e) of the Public Utility Holding Company Act of 1935 provides:

Sec. 11. *Simplification of holding company systems.* * * *

(e) In accordance with such rules and regulations or order as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out the terms and provisions of such plan, take exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed.

(b) *Registered holding company, holding-company system, and associate company.* (1) Under section 5 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79e), any holding company may register by filing with the Securities and Exchange Commission a notification of registration, in such form as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers. A holding company shall be deemed to be registered upon receipt by the Securities and Exchange Commission of such notification of registration. As used in this part, the term *registered holding company* means a holding company whose notification of registration has been so received and whose registration is still in effect under section 5 of the Public Utility Holding Company Act of 1935. Under section 2 (a)(7) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79b (a)(7)), a corporation is a holding company (unless it is declared not to be such by the Securities and Exchange Commission), if such corporation directly or indirectly owns, controls, or holds with power to vote 10 percent or more of the outstanding voting securities of a public-utility company (i.e., an electric utility company or a gas utility company as defined by such act) or of any other holding company. A corporation is also a holding

company if the Securities and Exchange Commission determines, after notice and opportunity for hearing, that such corporation directly or indirectly exercises (either alone or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public-utility company (i.e., an electric utility company or a gas utility company as defined by such act) or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such corporation be subject to the obligations, duties, and liabilities imposed upon holding companies by the Public Utility Holding Company Act of 1935 (15 U.S.C. ch. 2C). An electric utility company is defined by section 2 (a)(3) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79b (a)(3)) to mean a company which owns or operates facilities used for the generation, transmission, or distribution of electrical energy for sale, other than sale to tenants or employees of the company operating such facilities for their own use and not for resale; and a gas utility company is defined by section 2 (a)(4) of such act (15 U.S.C. 79b (a)(4)), to mean a company which owns or operates facilities used for the distribution at retail (other than distribution only in enclosed portable containers, or distribution to tenants or employees of the company operating such facilities for their own use and not for resale) of natural or manufactured gas for heat, light, or power. However, under certain conditions the Securities and Exchange Commission may declare a company not to be an electric utility company or a gas utility company, as the case may be, in which event the company shall not be considered an electric utility company or a gas utility company.

(2) The term *holding company system* has the meaning assigned to it by section 2 (a)(9) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79b (a)(9)), and hence means any holding company, together with all its subsidiary companies (i.e., subsidiary companies within the meaning of section 2(a)(8) of such act (15 U.S.C. 79b (a)(8)), which in general include all companies 10 percent of whose outstanding voting securities is owned directly or indirectly by such holding company) and all mutual service companies of which such holding company or any subsidiary company thereof is a member company. The term *mutual service company* means a company approved as a mutual service company under section 13 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79m). The term *member company* is defined by action 2 (a)(14) of such act (15 U.S.C. 79b (a)(14)), to mean a company which is a member of an association or group of companies mutually served by a mutual service company.

(3) The term *associate company* has the meaning assigned to it by section 2 (a)(10) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79b (a)(10)), and hence an associate company of a company is any company in the same holding-company system with such company.

(c) *Majority-owned subsidiary company*. The term *majority-owned subsidiary company* is defined in section 1083 (c). Direct ownership by a registered holding company of more than 50 percent of the specified stock of another corporation is not necessary to constitute such corporation a majority-owned subsidiary company. To illustrate, if the H Corporation, a registered holding company, owns 51 percent of the common stock of the A Corporation and 31 percent of the common stock of the B Corporation, and the A Corporation owns 20 percent of the common stock of the B Corporation (the common stock in each case being the only stock entitled to vote), both the A Corporation and the B Corporation are majority-owned subsidiary companies.

(d) *System group*. The term *system group* is defined in section 1083 (d) to mean one or more chains of corporations connected through stock ownership with a common parent corporation, if at least 90 percent of each class of stock (other than (1) stock which is preferred as to both dividends and assets, and (2) stock which is limited and preferred as to dividends but which is not preferred as to assets but only if the total value of such stock is less than 1 percent of the aggregate value

of all classes of stock which are not preferred as to both dividends and assets) of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations, and if the common parent corporation owns directly at least 90 percent of each class of stock (other than stock preferred as to both dividends and assets) of at least one of the other corporations; but no corporation is a member of a system group unless it is either a registered holding company or a majority-owned subsidiary company. While the type of stock which must, for the purpose of this definition, be at least 90 percent owned may be different from the voting stock which must be more than 50 percent owned for the purpose of the definition of a majority-owned subsidiary company under section 1083(c), as a general rule both types of ownership tests must be met under section 1083(d), since a corporation, in order to be a member of a system group, must also be a registered holding company or a majority-owned subsidiary company.

(e) *Nonexempt property*. The term *nonexempt property* is defined by section 1083(e) to include—

(1) The amount of any consideration in the form of a cancellation or assumption of debts or other liabilities of the transferor (including a continuance of encumbrances subject to which the property was transferred). To illustrate, if in obedience to an order of the Securities and Exchange Commission the X Corporation, a registered holding company, transfers property to the Y Corporation in exchange for property (not nonexempt property) with a fair market value of $500,000, the X Corporation receives $100,000 of nonexempt property, if for example—

(i) The Y Corporation cancels $100,000 of indebtedness owed to it by the X Corporation;

(ii) The Y Corporation assumes an indebtedness of $100,000 owed by the X Corporation to another company, the A Corporation; or

(iii) The Y Corporation takes over the property conveyed to it by the X Corporation subject to a mortgage of $100,000.

(2) Short-term obligations (including notes, drafts, bills of exchange, and bankers' acceptances) having a maturity at the time of issuance of not exceeding 24 months, exclusive of days of grace.

(3) Securities issued or guaranteed as to principal or interest by a government or subdivision thereof (including those issued by a corporation which is an instrumentality of a government or subdivision thereof).

(4) Stock or securities which were acquired from a registered holding company which acquired such stock or securities after February 28, 1938, or an associate company of a registered holding company which acquired such stock or securities after February 28, 1938, unless such stock or securities were acquired in obedience to an order of the Securities and Exchange Commission (as defined in section 1083 (a)) or were acquired with the authorization or approval of the Securities and Exchange Commission under any section of the Public Utility Holding Company Act of 1935, and are not nonexempt property within the meaning of section 1083(e) (1), (2), or (3).

(5) Money, and the right to receive money not evidenced by a security other than an obligation described as nonexempt property in section 1083 (e) (2) or (3). The term *the right to receive money* includes, among other items, accounts receivable, claims for damages, and rights to refunds of taxes.

(f) *Stock or securities*. The term *stock or securities* is defined in section 1083(f) for the purposes of part VI (section 1081 and following), subchapter O, chapter 1 of the Code. As therein defined, the term includes voting trust certificates and stock rights or warrants.

WASH SALES OF STOCK OR SECURITIES

§ 1.1091–1 Losses from wash sales of stock or securities.

(a) A taxpayer cannot deduct any loss claimed to have been sustained from the sale or other disposition of stock or securities if, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date (referred to in this section as the 61-day period), he has acquired (by purchase or by an exchange

upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities. However, this prohibition does not apply (1) in the case of a taxpayer, not a corporation, if the sale or other disposition of stock or securities is made in connection with the taxpayer's trade or business, or (2) in the case of a corporation, a dealer in stock or securities, if the sale or other disposition of stock or securities is made in the ordinary course of its business as such dealer.

(b) Where more than one loss is claimed to have been sustained within the taxable year from the sale or other disposition of stock or securities, the provisions of this section shall be applied to the losses in the order in which the stock or securities the disposition of which resulted in the respective losses were disposed of (beginning with the earliest disposition). If the order of disposition of stock or securities disposed of at a loss on the same day cannot be determined, the stock or securities will be considered to have been disposed of in the order in which they were originally acquired (beginning with the earliest acquisition).

(c) Where the amount of stock or securities acquired within the 61-day period is less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the loss from the sale or other disposition of which is not deductible shall be those with which the stock or securities acquired are matched in accordance with the following rule: The stock or securities acquired will be matched in accordance with the order of their acquisition (beginning with the earliest acquisition) with an equal number of the shares of stock or securities sold or otherwise disposed of.

(d) Where the amount of stock or securities acquired within the 61-day period is not less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the acquisition of which resulted in the nondeductibility of the loss shall be those with which the stock or securities disposed of are matched in accordance with the following rule: The stock or securities sold or otherwise disposed of will be matched with an equal number of the shares of stock or securities acquired in accordance with the order of acquisition (beginning with the earliest acquisition) of the stock or securities acquired.

(e) The acquisition of any share of stock or any security which results in the nondeductibility of a loss under the provisions of this section shall be disregarded in determining the deductibility of any other loss.

(f) The word *acquired* as used in this section means acquired by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law, and comprehends cases where the taxpayer has entered into a contract or option within the 61-day period to acquire by purchase or by such an exchange.

(g) For purposes of determining under this section the 61-day period applicable to a short sale of stock or securities, the principles of paragraph (a) of §1.1233–1 for determining the consummation of a short sale shall generally apply except that the date of entering into the short sale shall be deemed to be the date of sale if, on the date of entering into the short sale, the taxpayer owns (or on or before such date has entered into a contract or option to acquire) stock or securities identical to those sold short and subsequently delivers such stock or securities to close the short sale.

(h) The following examples illustrate the application of this section:

Example 1. A, whose taxable year is the calendar year, on December 1, 1954, purchased 100 shares of common stock in the M Company for $10,000 and on December 15, 1954, purchased 100 additional shares for $9,000. On January 3, 1955, he sold the 100 shares purchased on December 1, 1954, for $9,000. Because of the provisions of section 1091, no loss from the sale is allowable as a deduction.

Example 2. A, whose taxable year is the calendar year, on September 21, 1954, purchased 100 shares of the common stock of the M Company for $5,000. On December 21, 1954, he purchased 50 shares of substantially identical stock for $2,750, and on December 27, 1954, he purchased 25 additional shares of such stock for $1,125. On January 3, 1955, he sold for $4,000 the 100 shares purchased on September 21, 1954. There is an indicated loss

of $1,000 on the sale of the 100 shares. Since, within the 61-day period, A purchased 75 shares of substantially identical stock, the loss on the sale of 75 of the shares ($3,750 − $3,000, or $750) is not allowable as a deduction because of the provisions of section 1091. The loss on the sale of the remaining 25 shares ($1,250 − $1,000, or $250) is deductible subject to the limitations provided in sections 267 and 1211. The basis of the 50 shares purchased December 21, 1954, the acquisition of which resulted in the nondeductibility of the loss ($500) sustained on 50 of the 100 shares sold on January 3, 1955, is $2,500 (the cost of 50 of the shares sold on January 3, 1955) + $750 (the difference between the purchase price ($2,750) of the 50 shares acquired on December 21, 1954, and the selling price ($2,000) of 50 of the shares sold on January 3, 1955), or $3,250. Similarly, the basis of the 25 shares purchased on December 27, 1954, the acquisition of which resulted in the nondeductibility of the loss ($250) sustained on 25 of the shares sold on January 3, 1955, is $1,250 + $125, or $1,375. See § 1.1091–2.

Example 3. A, whose taxable year is the calendar year, on September 15, 1954, purchased 100 shares of the stock of the M Company for $5,000. He sold these shares on February 1, 1956, for $4,000. On each of the four days from February 15, 1956, to February 18, 1956, inclusive, he purchased 50 shares of substantially identical stock for $2,000. There is an indicated loss of $1,000 from the sale of the 100 shares on February 1, 1956, but, since within the 61-day period A purchased not less than 100 shares of substantially identical stock, the loss is not deductible. The particular shares of stock the purchase of which resulted in the nondeductibility of the loss are the first 100 shares purchased within such period, that is, the 50 shares purchased on February 15, 1956, and the 50 shares purchased on February 16, 1956. In determining the period for which the 50 shares purchased on February 15, 1956, and the 50 shares purchased on February 16, 1956, were held, there is to be included the period for which the 100 shares purchased on September 15, 1954, and sold on February 1, 1956, were held.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6926, 32 FR 11468, Aug. 9, 1967]

§ 1.1091–2 Basis of stock or securities acquired in "wash sales".

(a) *In general.* The application of section 1091(d) may be illustrated by the following examples:

Example 1. A purchased a share of common stock of the X Corporation for $100 in 1935, which he sold January 15, 1955, for $80. On February 1, 1955, he purchased a share of common stock of the same corporation for $90. No loss from the sale is recognized under section 1091. The basis of the new share is $110; that is, the basis of the old share ($100) increased by $10, the excess of the price at which the new share was acquired ($90) over the price at which the old share was sold ($80).

Example 2. A purchased a share of common stock of the Y Corporation for $100 in 1935, which he sold January 15, 1955, for $80. On February 1, 1955, he purchased a share of common stock of the same corporation for $70. No loss from the sale is recognized under section 1091. The basis of the new share is $90; that is, the basis of the old share ($100) decreased by $10, the excess of the price at which the old share was sold ($80) over the price at which the new share was acquired ($70).

(b) *Special rule.* For a special rule as to the adjustment to basis required under section 1091(d) in the case of wash sales involving certain regulated investment company stock for which there is an average basis, see paragraph (e)(3)(iii) (*c*) and (*d*) of § 1.1012–1.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7129, 36 FR 12738, July 7, 1971]

§ 1.1092(b)–1T Coordination of loss deferral rules and wash sale rules (temporary).

(a) *In general.* Except as otherwise provided, in the case of the disposition of a position or positions of a straddle, the rules of paragraph (a)(1) of this section apply before the application of the rules of paragraph (a)(2) of this section.

(1) Any loss sustained from the disposition of shares of stock or securities that constitute positions of a straddle shall not be taken into account for purposes of this subtitle if, within a period beginning 30 days before the date of such disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange on which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities.

(2) Except as otherwise provided, if a taxpayer disposes of less than all of the positions of a straddle, any loss sustained with respect to the disposition of that position or positions (hereinafter referred to as *loss position*) shall not be taken into account for purposes of this subtitle to the extent that the amount of unrecognized gain as of the

close of the taxable year in one or more of the following positions—

(i) Successor positions,

(ii) Offsetting positions to the loss position, or

(iii) Offsetting positions to any successor position,

exceeds the amount of loss disallowed under paragraph (a)(1) of this section. See §1.1092(b)–5T relating to definitions.

(b) *Carryover of disallowed loss.* Any loss that is disallowed under paragraph (a) of this section shall, subject to any further application of paragraph (a)(1) of this section and the limitations under paragraph (a)(2) of this section, be treated as sustained in the succeeding taxable year. However, a loss disallowed in Year 1, for example, under paragraph (a)(1) of this section will not be allowed in Year 2 unless the substantially identical stock or securities, the acquisition of which caused the loss to be disallowed in Year 1, are disposed of during Year 2 and paragraphs (a)(1) and (a)(2) of this section do not apply in Year 2 to disallow the loss.

(c) *Treatment of disallowed loss*—(1) *Character.* If the disposition of a loss position would (but for the application of this section) result in a capital loss, the loss allowed under paragraph (b) of this section with respect to the disposition of the loss position shall be treated as a capital loss. In any other case, a loss allowed under paragraph (b) of this section shall be treated as an ordinary loss. For example, if the disposition of a loss position would, but for the application of paragraph (a) of this section, give rise to a capital loss, that loss when allowed pursuant to paragraph (b) of this section will be treated as a capital loss on the date the loss is allowed regardless of whether any gain or loss with respect to one or more successor positions would be treated as ordinary income or loss.

(2) *Section 1256 contracts.* If the disposition of a loss position would (but for the application of this section) result in 60 percent long-term capital loss and 40 percent short-term capital loss, the loss allowed under paragraph (b) of this section with respect to the disposition of the loss position shall be treated as 60 percent long-term capital loss and 40 percent short-term capital loss regardless of whether any gain or loss with respect to one or more successor positions would be treated as 100 percent long-term or short-term capital gain or loss.

(d) *Exceptions.* (1) This section shall not apply to losses sustained—

(i) With respect to the disposition of one or more positions that constitute part of a hedging transaction;

(ii) With respect to the disposition of a loss position included in a mixed straddle account (as defined in paragraph (b) of §1.1092(b)–4T); and

(iii) With respect to the disposition of a position that is part of a straddle consisting only of section 1256 contracts.

(2) Paragraph (a)(1) of this section shall not apply to losses sustained by a dealer in stock or securities if such losses are sustained in a transaction made in the ordinary course of such business.

(e) *Coordination with section 1091.* Section 1092(b) applies in lieu of section 1091 to losses sustained from the disposition of positions in a straddle. See example (18) of paragraph (g) of this section.

(f) *Effective date.* The provisions of this section apply to dispositions of loss positions on or after January 24, 1985.

(g) *Examples.* This section may be illustrated by the following examples. It is assumed in each example that the following positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year and none of the exceptions contained in paragraph (d) of this section apply.

Example 1. On December 1, 1985, A enters into offsetting long and short positions. On December 10, 1985, A disposes of the short position at an $11 loss, at which time there is $5 of unrealized gain in the offsetting long position. At year-end there is still $5 of unrecognized gain in the offsetting long position. Under these circumstances, $5 of the $11 loss will be disallowed for 1985 because there is $5 of unrecognized gain in the offsetting long position; the remaining $6 of loss, however, will be taken into account in 1985.

Example 2. Assume the facts are the same as in example (1), except that at year-end

there is $11 of unrecognized gain in the offsetting long position. Under these circumstances, the entire $11 loss will be disallowed for 1985 because there is $11 of unrecognized gain at year-end in the offsetting long position.

Example 3. Assume the facts are the same as in example (1), except that at year-end there is no unrecognized gain in the offsetting long position. Under these circumstances, the entire $11 loss will be allowed for 1985.

Example 4. On November 1, 1985, A enters into offsetting long and short positions. On November 10, 1985, A disposes of the long position at a $10 loss, at which time there is $10 of unrealized gain in the short position. On November 11, 1985, A enters into a new long position (successor position) that is offsetting with respect to the retained short position but is not substantially identical to the long position disposed of on November 10, 1985. A holds both positions through year-end, at which time there is $10 of unrecognized gain in the successor long position and no unrecognized gain in the offsetting short position. Under these circumstances, the entire $10 loss will be disallowed for 1985 because there is $10 of unrecognized gain in the successor long position.

Example 5. Assume the facts are the same as in example (4), except that at year-end there is $4 of unrecognized gain in the successor long position and $6 of unrecognized gain in the offsetting short position. Under these circumstances, the entire $10 loss will be disallowed for 1985 because there is a total of $10 of unrecognized gain in both the successor long position and offsetting short position.

Example 6. Assume the facts are the same as in example (4), except that at year-end A disposes of the offsetting short position at a $2 loss. Under these circumstances, $10 of the total $12 loss will be disallowed because there is $10 of unrecognized gain in the successor long position.

Example 7. Assume the facts are the same as in example (4), and on January 10, 1986, A disposes of the successor long position at no gain or loss. A holds the offsetting short position until year-end, at which time there is $10 of unrecognized gain. Under these circumstances, the $10 loss will be disallowed for 1986 because there is $10 of unrecognized gain in an offsetting position at year-end.

Example 8. Assume the facts are the same as in example (4), except at year-end there is $8 of unrecognized gain in the successor long position and $8 of unrecognized loss in the offsetting short position. Under these circumstances, $8 of the total $10 realized loss will be disallowed because there is $8 of unrecognized gain in the successor long position.

Example 9. On October 1, 1985, A enters into offsetting long and short positions. Neither the long nor the short position is stock or securities. On October 2, 1985, A disposes of the short position at a $10 loss and the long position at a $10 gain. On October 3, 1985, A enters into a long position identical to the original long position. At year-end there is $10 of unrecognized gain in the second long position. Under these circumstances, the $10 loss is allowed because the second long position is not a successor position or offsetting position to the short loss position.

Example 10. On November 1, 1985, A enters into offsetting long and short positions. On November 10, 1985, there is $20 of unrealized gain in the long position and A disposes of the short position at a $20 loss. By November 15, 1985, the value of the long position has declined eliminating all unrealized gain in the position. On November 15, 1985, A establishes a second short position (successor position) that is offsetting with respect to the long position but is not substantially identical to the short position disposed of on November 10, 1985. At year-end there is no unrecognized gain in the offsetting long position or in the successor short position. Under these circumstances, the $20 loss sustained with respect to the short loss position will be allowed for 1985 because at year-end there is no unrecognized gain in the successor short position or the offsetting long position.

Example 11. Assume the facts are the same as in example (10), except that the second short position was established on November 8, 1985, and there is $20 of unrecognized gain in the second short position at year-end. Since the second short position was entered into within 30 days before the disposition of the loss position, the second short position is considered a successor position to the loss position. Under these circumstances, the $20 loss will be disallowed because there is $20 of unrecognized gain in a successor position.

Example 12. Assume the facts are the same as in example (10), except that at year-end there is $18 of unrecognized gain in the offsetting long position and $18 of unrecognized gain in the successor short position. Under these circumstances, the entire loss will be disallowed because there is more than $20 of unrecognized gain in both the successor short position and offsetting long position.

Example 13. Assume the facts are the same as in example (10), except that there is $20 of unrecognized gain in the successor short position and no unrecognized gain in the offsetting long position at year-end. Under these circumstances, the entire $20 loss will be disallowed because there is $20 of unrecognized gain in the successor short position.

Example 14. On January 2, 1986, A enters into offsetting long and short positions. Neither the long nor the short position is stock or securities. On March 3, 1986, A disposes of the long position at a $10 gain. On March 10, 1986, A disposes of the short position at a $10 loss. On March 14, 1986, A enters into a new

short position. On April 10, 1986, A enters into an offsetting long position. A holds both positions to year-end, at which time there is $10 of unrecognized gain in the offsetting long position and no unrecognized gain or loss in the short position. Under these circumstances, the $10 loss will be allowed because (1) the rules of paragraph (a)(1) of this section are not applicable; and (2) the rules of paragraph (a)(2) of this section do not apply, since all positions of the straddle that contained the loss position were disposed of.

Example 15. On December 1, 1985, A enters into offsetting long and short positions. On December 4, 1985, A disposes of the short position at a $10 loss. On December 5, 1985, A establishes a new short position that is offsetting to the long position, but is not substantially identical to the short position disposed of on December 4, 1985. On December 6, 1985, A disposes of the long position at a $10 gain. On December 7, 1985, A enters into a second long position that is offsetting to the new short position, but is not substantially identical to the long position disposed of on December 6, 1985. A holds both positions to year-end at which time there is no unrecognized gain in the second short position and $10 of unrecognized gain in the offsetting long position. Under these circumstances, the entire $10 loss will be disallowed for the 1985 taxable year because the second long position is an offsetting position with respect to the second short position which is a successor position.

Example 16. On September 1, 1985, A enters into offsetting positions consisting of a long section 1256 contract and short non-section 1256 position. No elections under sections 1256(d)(1) or 1092(b)(2)(A), relating to mixed straddles, are made. On November 1, 1985, at which time there is $20 of unrecognized gain in the short non-section 1256 position, A disposes of the long section 1256 contract at a $20 loss and on the same day acquires a long non-section 1256 position (successor position) that is offsetting with respect to the short non-section 1256 position. But for the application of this section, A's disposition of the section 1256 contract would give rise to a capital loss. At year-end there is a $20 of unrecognized gain in the offsetting short non-section 1256 position and no unrecognized gain in the successor long position. Under these circumstances, the entire $20 loss will be disallowed for 1985 because there is $20 unrecognized gain in the offsetting short position. In 1986, A disposes of the successor long non-section 1256 position and there is no unrecognized gain at year-end in the offsetting short position. Under these circumstances, the $20 loss disallowed in 1985 with respect to the section 1256 contract will be treated in 1986 as 60 percent long-term capital loss and 40 percent short-term capital loss.

Example 17. On January 2, 1986, A, not a dealer in stock or securities, acquires stock in X Corporation (X stock) and an offsetting put option. On March 3, 1986, A disposes of the X stock at a $10 loss. On March 10, 1986, A disposes of the put option at a $10 gain. On March 14, 1986, A acquires new X stock that is substantially identical to the X stock disposed of on March 3, 1986. A holds the X stock to year-end. Under these circumstances, the $10 loss will be disallowed for 1986 under paragraph (a)(1) of this section because A, within a period beginning 30 days before March 3, 1986 and ending 30 days after such date, acquired stock substantially identical to the X stock disposed of.

Example 18. On June 2, 1986, A, not a dealer in stock or securities, acquires stock in X Corporation (X stock). On September 2, 1986, A disposes of the X stock at a $100 loss. On September 15, 1986, A acquires new X stock that is substantially identical to the X stock disposed of on September 2, 1986, and an offsetting put option. A holds these straddle positions to year-end. Under these circumstances, section 1091, rather than section 1092(b), will apply to disallow the $100 loss for 1986 because the loss was not sustained from the disposition of a position that was part of a straddle. See paragraph (e) of this section.

Example 19. On November 1, 1985, A, not a dealer in stock or securities, acquires stock in Y Corporation (Y stock) and an offsetting put option. On November 12, 1985, there is $20 of unrealized gain in the put option and A disposes of the Y stock at a $20 loss. By November 15, 1985, the value of the put option has declined eliminating all unrealized gain in the position. On November 15, 1985, A acquires a second Y stock position that is substantially identical to the Y stock disposed of on November 12, 1985. At year-end there is no unrecognized gain in the put option or the Y stock. Under these circumstances, the $20 loss will be disallowed for 1985 under paragraph (a)(1) of this section because A, within a period beginning 30 days before November 12, 1985 and ending 30 days after such date, acquired stock substantially identical to the Y stock disposed of.

Example 20. Assume the facts are the same as in Example 19 and that on December 31, 1986, A disposes of the put option at a $40 gain and there is $20 of unrecognized loss in the Y stock. Under these circumstances, the $20 loss which was disallowed in 1985 also will be disallowed for 1986 under the rules of paragraph (a)(1) of this section because A has not disposed of the stock substantially identical to the Y stock disposed of on November 12, 1985.

Example 21. Assume the facts are the same as in example (19), except that on December 31, 1986, A disposes of the Y stock at a $20 loss and there is $40 of unrecognized gain in the put option. Under these circumstances, A will not recognize in 1986 either the $20 loss disallowed in 1985 or the $20 loss sustained

with respect to the December 31, 1986 disposition of Y stock. Paragraph (a)(1) of this section does not apply to disallow the losses in 1986 since the substantially identical Y stock was disposed of during the year (and no substantially identical stock or securities was acquired by A within the 61 day period). However, paragraph (a)(2) of this section applies to disallow for 1986 the $40 of losses sustained with respect to the dispositions of positions in the straddle because there is $40 of unrecognized gain in the put option, an offsetting position to the loss positions.

Example 22. On January 2, 1986, A, not a dealer in stock or securities, acquires stock in X Corporation (X stock) and an offsetting put option. On March 3, 1986, A disposes of the X stock at a $10 loss. On March 17, 1986, A acquires new X stock that is substantially identical to the X stock disposed of on March 3, 1986. On December 31, 1986, A disposes of the X stock at a $5 gain, at which time there is $5 of unrecognized gain in the put option. Under these circumstances, the $10 loss sustained with respect to the March 3, 1986, disposition of X stock will be allowed under paragraph (a) (1) of this section since the substantially identical X stock acquired on March 17, 1986, was disposed of by year-end (and no substantially identical stock or securities were acquired by A within the 61 day period). However, $5 of the $10 loss will be disallowed under paragraph (a)(2) of this section because there is $5 of unrecognized gain in the put option, an offsetting position to the loss position.

Example 23. Assume the facts are the same as in example (22), except that on December 31, 1986, A disposes of the offsetting put option at a $5 loss and there is $5 of unrecognized gain in the X stock acquired on March 17, 1986. Under these circumstances, the $10 loss sustained with respect to the X stock disposed of on March 3, 1986, will be disallowed for 1986 under paragraph (a)(1) of this section. The $5 loss sustained upon the disposition of the put option will be allowed because (1) the rules of paragraph (a)(1) of this section are not applicable; and (2) the rules of paragraph (a)(2) of this section allow the loss, since the unrecognized gain in the X stock ($5) is not in excess of the loss ($10) disallowed under paragraph (a)(1) of this section.

Example 24. On January 2, 1986, A, not a dealer in stock or securities, acquires 200 shares of Z Corporation stock (Z stock) and 2 put options on Z stock (giving A the right to sell 200 shares of Z stock). On September 2, 1986, there is $200 of unrealized gain in the put option positions and A disposes of the 200 shares of Z stock at a $200 loss. On September 10, 1986, A acquires 100 shares of Z stock (substantially identical to the Z stock disposed of on September 2, 1986), and a call option that is offsetting to the put options on Z stock and that is not an option to acquire property substantially identical to the Z stock disposed of on September 2, 1986. At year-end, there is $80 of unrecognized gain in the Z stock position, $80 of unrecognized gain in the call option position, and no unrecognized gain or loss in the offsetting put option positions. Under these circumstances, $40 of the $200 loss sustained with respect to the September 2, 1986 disposition of Z stock will be recognized by A in 1986 under paragraph (a) of this section, as set forth below. Paragraph (a)(1) of this section applies first to disallow $100 of the loss (½ of the loss), since 100 shares of substantially identical Z stock (½ of the stock) were acquired within the 61 day period. Paragraph (a)(2) of this section then applies to disallow that portion of the loss allowed under paragraph (a)(1) of this section ($200 − $100 = $100) equal to the excess of the total unrecognized gain in the Z stock and call option positions (successor positions to the loss position) ($80 + $80 = $160) over the $100 loss disallowed under paragraph (a)(1) of this section ($160 − $100 = $60; $100 − $60 = $40).

Example 25. Assume the facts are the same as in example (24), except that at year-end there is $110 of unrecognized gain in the Z stock position, $78 of unrecognized gain in the call option position, and $10 of unrecognized gain in the offsetting put option positions. Under these circumstances, $2 of the $200 loss sustained with respect to the September 2, 1986 disposition of Z stock will be allowed in 1986 under paragraph (a) of this section, as set forth below. Paragraph (a)(1) of this section applies first to disallow $100 of the loss (½ of the loss) since 100 shares of substantially identical Z stock (½ of the stock) were acquired within the 61 day period. Paragraph (a)(2) of this section then applies to disallow that portion of the loss allowed under paragraph (a)(1) of this section ($200 − $100 = $100) equal to the excess of the total unrecognized gain in the Z stock and call option positions (successor positions to the loss position) and the put option positions (offsetting positions to the loss position) ($110 + $78 + $10 = $198) over the $100 loss disallowed under paragraph (a)(1) of this section ($198 − $100 = $98; $100 − $98 = $2).

Example 26. Assume the facts are the same as in example (24), except that at year-end there is $120 of unrecognized gain in the Z stock position, $88 of unrecognized gain in the call option position, and $10 of unrecognized loss in one of the offsetting put option positions. At year-end A disposes of the other put option position at a $10 loss. Under these circumstances, $2 of the $210 loss sustained with respect to the September 2, 1986 disposition of Z stock ($200) and the year-end disposition of a put option ($10) will be allowed in 1986 under paragraph (a) of this section, as set forth below. Paragraph (a)(1) of this section applies first to disallow $100 of the loss from the disposition of Z stock (½ of

the loss), since 100 shares of substantially identical Z stock (½ of the stock) were acquired within the 61 day period. Paragraph (a)(2) of this section then applies to disallow that portion of the loss allowed under paragraph (a)(1) of this section ($210 – $100 = $110) equal to the excess of the total unrecognized gain in the Z stock and call option positions (successor positions to the Z stock loss position, and offsetting positions to the put option loss position) ($120 + $88 = $208) over the $100 loss disallowed under paragraph (a)(1) of this section ($208 – $100 = $108; $110 – $108 = $2).

Example 27. On January 27, 1986, A enters into offsetting long (L1) and short (S1) positions. Neither L1 nor S1 nor any other positions entered into by A in 1986 are stock or securities. On February 3, 1986, A disposes of L1 at a $10 loss. On February 5, 1986, A enters into a new long position (L2) that is offsetting to S1. On October 15, 1986, A disposes of S1 at an $11 loss. On October 17, 1986, A enters into a new short position (S2) that is offsetting to L2. On December 30, 1986, A disposes of L2 at a $12 loss. On December 31, 1986, A enters into a new long position (L3) that is offsetting to S2. At year-end, S2 has an unrecognized gain of $33. Paragraph (a)(1) of this section does not apply since none of the positions were shares of stock or securities. However, all $33 ($10 + $11 + $12) of the losses sustained with respect to L1, S1 and L2 will be disallowed under paragraph (a)(2) because there is $33 of unrecognized gain in S2 at year-end. The $10 loss from the disposition of L1 is disallowed because S2 is or was an offsetting position to a successor long position (L2 or L3). The $11 loss from the disposition of S1 is disallowed because S2 is a successor position to S1. The $12 loss from the disposition of L2 is disallowed because S2 was an offsetting position to L2.

(Secs. 1092(b) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 95 Stat. 324, 26 U.S.C. 1092(b), 7805) and sec. 102(h) of the Tax Reform Act of 1984 (98 Stat. 625))

[T.D. 8007, 50 FR 3319, Jan. 24, 1985, as amended by T.D. 8070, 51 FR 1786, Jan. 15, 1986; 51 FR 3773, Jan. 30, 1986; 51 FR 5516, Feb. 14, 1986]

§ 1.1092(b)–2T Treatment of holding periods and losses with respect to straddle positions (temporary).

(a) *Holding period*—(1) *In general.* Except as otherwise provided in this section, the holding period of any position that is part of a straddle shall not begin earlier than the date the taxpayer no longer holds directly or indirectly (through a related person or flowthrough entity) an offsetting position with respect to that position. See § 1.1092(b)–5T relating to definitions.

(2) *Positions held for the long-term capital gain holding period (or longer) prior to establishment of the straddle.* Paragraph (a)(1) of this section shall not apply to a position held by a taxpayer for the long-term capital gain holding period (or longer) before a straddle that includes such position is established. The determination of whether a position has been held by a taxpayer for the long-term capital gain holding period (or longer) shall be made by taking into account the application of paragraph (a)(1) of this section. See section 1222(3) relating to the holding period for long-term capital gains.

(b) *Treatment of loss*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, loss on the disposition of one or more positions (*loss position*) of a straddle shall be treated as a long-term capital loss if—

(i) On the date the taxpayer entered into the loss position the taxpayer held directly or indirectly (through a related person or flowthrough entity) one or more offsetting positions with respect to the loss position; and

(ii) All gain or loss with respect to one or more positions in the straddle would be treated as long-term capital gain or loss if such positions were disposed of on the day the loss position was entered into.

(2) *Special rules for non-section 1256 positions in a mixed straddle.* Loss on the disposition of one or more positions (*loss position*) that are part of a mixed straddle and that are non-section 1256 positions shall be treated as 60 percent long-term capital loss and 40 percent short-term capital loss if—

(i) Gain or loss from the disposition of one or more of the positions of the straddle that are section 1256 contracts would be considered gain or loss from the sale or exchange of a capital asset;

(ii) The disposition of no position in the straddle (other than a section 1256 contract) would result in a long-term capital gain or loss; and

(iii) An election under section 1092(b)(2)(A)(i)(I) (relating to straddle-by-straddle identification) or 1092(b)(2)(A)(i)(II) (relating to mixed straddle accounts) has not been made.

(c) *Exceptions*—(1) *In general.* This section shall not apply to positions that—

(i) Constitute part of a hedging transaction;

(ii) Are included in a straddle consisting only of section 1256 contracts; or

(iii) Are included in a mixed straddle account (as defined in paragraph (b) of § 1.1092(b)–4T).

(2) *Straddle-by-straddle identification.* Paragraphs (a)(2) and (b) of this section shall not apply to positions in a section 1092(b)(2) identified mixed straddle. See § 1.1092(b)–3T.

(d) *Special rule for positions held by regulated investment companies.* For purposes of section 851(b)(3) (relating to the definition of a regulated investment company), the holding period rule of paragraph (a) of this section shall not apply to positions of a straddle. However, if section 1233(b) (without regard to sections 1233(e)(2)(A) and 1092(b)) would have applied to such positions, then for purposes of section 851(b)(3) the rules of section 1233(b) shall apply. Similarly, the effect of daily marking-to-market provided under § 1.1092(b)–4T(c) will be disregarded for purposes of section 851(b)(3).

(e) *Effective date*—(1) *In general.* Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to positions in a straddle established after June 23, 1981, in taxable years ending after such date.

(2) *Special effective date for mixed straddle positions.* The provisions of paragraph (b)(2) of this section shall apply to positions in a mixed straddle established on or after January 1, 1984.

(f) *Examples.* Paragraphs (a) through (e) may be illustrated by the following examples. It is assumed in each example that the following positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year and none of the exceptions in paragraph (c) of this section apply.

Example 1. On October 1, 1984, A acquires gold. On January 1, 1985, A enters into an offsetting short gold forward contract. On April 1, 1985, A disposes of the short gold forward contract at no gain or loss. On April 10, 1985, A sells the gold at a gain. Since the gold had not been held for more than 6 months before the offsetting short position was entered into, the holding period for the gold begins no earlier than the time the straddle is terminated. Thus, the holding period of the original gold purchased on October 1, 1984, and sold on April 10, 1985, begins on April 1, 1985, the date the straddle was terminated. Consequently, gain recognized with respect to the gold will be treated as short-term capital gain.

Example 2. On January 1, 1985, A enters into a long gold forward contract. On May 1, 1985, A enters into an offsetting short gold regulated futures contract. A does not make an election under section 1256(d) or 1092(b)(2)(A). On August 1, 1985, A disposes of the gold forward contract at a gain. Since the forward contract had not been held by A for more than 6 months prior to the establishment of the straddle, the holding period for the forward contract begins no earlier than the time the straddle is terminated. Thus, the gain recognized on the closing of the gold forward contract will be treated as short-term capital gain.

Example 3. Assume the facts are the same as in example (2), except that A disposes of the short gold regulated futures contract on July 1, 1985, at no gain or loss and the forward contract on November 1, 1985. Since the forward contract had not been held for more than 6 months before the mixed straddle was established, the holding period for the forward contract begins July 1, 1985, the date the straddle terminated. Thus, the gain recognized on the closing of the forward contract will be treated as short-term capital gain.

Example 4. On January 1, 1985, A enters into a long gold forward contract and on August 4, 1985, A enters into an offsetting short gold forward contract. On September 1, 1985, A disposes of the short position at a loss. Since an offsetting long position had been held by A for more than 6 months prior to the acquisition of the offsetting short position, the loss with respect to the closing of the short position will be treated as long-term capital loss.

Example 5. On March 1, 1985, A enters into a long gold forward contract and on July 17, 1985, A enters into an offsetting short gold regulated futures contract. A does not make an election under section 1256(d) or 1092(b)(2)(A). On August 10, 1985, A disposes of the long gold forward contract at a loss. Since the gold forward contract was part of a mixed straddle, and the disposition of no position in the straddle (other than the regulated futures contract) would give rise to a long-term capital loss, the loss recognized on the termination of the gold forward contract will be treated as 40 percent short-term capital loss and 60 percent long-term capital loss.

Example 6. Assume the facts are the same as in example (5), except that on August 11, 1985, A disposes of the short gold regulated

futures contract at a gain. Under these circumstances, the gain will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain since the holding period rules of paragraph (a) of this section are not applicable to section 1256 contracts.

Example 7. Assume the facts are the same as in example (5), except that A enters into the long gold forward contract on January 1, 1985, and does not dispose of the long gold forward contract but instead on August 10, 1985, disposes of the short gold regulated futures contract at a loss. Under these circumstances, the loss will be treated as a long-term capital loss since A held an offsetting non-section 1256 position for more than 6 months prior to the establishment of the straddle. However, such loss may be subject to the rules of § 1.1092(b)–1T.

(Secs. 1092(b) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 95 Stat. 324, 26 U.S.C. 1092(b), 7805) and sec. 102(h) of the Tax Reform Act of 1984 (98 Stat. 625))

[T.D. 8007, 50 FR 3320, Jan. 24, 1985, as amended by T.D. 8070, 51 FR 1788, Jan. 15, 1986]

§ 1.1092(b)–3T Mixed straddles; straddle-by-straddle identification under section 1092(b)(2)(A)(i)(I) (Temporary).

(a) *In general.* Except as otherwise provided, a taxpayer shall treat in accordance with paragraph (b) of this section gains and losses on positions that are part of a mixed straddle for which the taxpayer has made an election under paragraph (d) of this section (hereinafter referred to as a *section 1092(b)(2) identified mixed straddle*). No election may be made under this section for any straddle composed of one or more positions that are includible in a mixed straddle account (as defined in paragraph (b) of § 1.1092(b)–4T) or for any straddle for which an election under section 1256(d) has been made. See § 1.1092(b)–5T relating to definitions.

(b) *Treatment of gains and losses from positions included in a section 1092(b)(2) identified mixed straddle*—(1) *In general.* Gains and losses from positions that are part of a section 1092(b)(2) identified mixed straddle shall be determined and treated in accordance with the rules of paragraph (b) (2) through (7) of this section.

(2) *All positions of a section 1092(b)(2) identified mixed straddle are disposed of on the same day.* If all positions of a section 1092(b)(2) identified mixed straddle are disposed of (or deemed disposed of) on the same say, gains and losses from section 1256 contracts in the straddle shall be netted, and gains and losses from non-section 1256 positions in the straddle shall be netted. Net gain or loss from the section 1256 contracts shall then be offset against net gain or loss from the non-section 1256 positions to determine the net gain or loss from the straddle. If net gain or loss from the straddle is attributable to the positions of the straddle that are section 1256 contracts, such gain or loss shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. If net gain or loss from the straddle is attributable to the positions of the straddle that are non-section 1256 positions, such gain or loss shall be treated as short-term capital gain or loss. This paragraph (b)(2) may be illustrated by the following examples. It is assumed in each example that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year.

Example 1. On April 1, 1985, A enters into a non-section 1256 position and an offsetting section 1256 contract and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On April 10, 1985, A disposes of the non-section 1256 position at a $600 loss and the section 1256 contract at a $600 gain. Under these circumstances, the $600 loss on the non-section 1256 position will be offset against the $600 gain on the section 1256 contract and the net gain or loss from the straddle will be zero.

Example 2. Assume the facts are the same as in example (1), except that the gain on the section 1256 contract is $800. Under these circumstances, the $600 loss on the non-section 1256 position will be offset against the $800 gain on the section 1256 contract. The net gain of $200 from the straddle will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain because it is attributable to the section 1256 contract.

Example 3. Assume the facts are the same as in example (1), except that the loss on the non-section 1256 position is $800. Under these circumstances, the $600 gain on the section 1256 contract will be offset against the $800 loss on the non-section 1256 position. The net loss of $200 from the straddle will be treated as short-term capital loss because it is attributable to the non-section 1256 position.

Example 4. On May 1, 1985, A enters into a straddle consisting of two non-section 1256 positions and two section 1256 contracts and makes a valid election to treat the straddle as a section 1092(b)(2) identified mixed straddle. On May 10, 1985, A disposes of the non-section 1256 positions, one at a $700 loss and the other at a $500 gain, and disposes of the section 1256 contracts, one at a $400 gain and the other at a $300 loss. Under these circumstances, the gain and losses from the section 1256 contracts and non-section 1256 positions will first be netted, resulting in a net gain of $100 ($400–$300) on the section 1256 contracts and a net loss of $200 ($700–$500) on the non-section 1256 positions. The net gain of $100 from the section 1256 contracts will then be offset against the $200 net loss on the non-section 1256 positions. The net loss of $100 from the straddle will be treated as short-term capital loss because it is attributable to the non-section 1256 positions.

Example 5. On December 30, 1985, A enters into a section 1256 contract and an offsetting non-section 1256 position and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On December 31, 1985, A disposes of the non-section 1256 position at a $2,000 gain. A also realizes a $2,000 loss on the section 1256 contract because it is deemed disposed of under section 1256(a)(1). Under these circumstances, the $2,000 gain on the non-section 1256 position will be offset against the $2,000 loss on the section 1256 contract, and the net gain or loss from the straddle will be zero.

Example 6. Assume the facts are the same as in example (5), except that the section 1092(b)(2) identified mixed straddle was entered into on November 12, 1985, A realizes a $2,200 loss on the section 1256 contract, and on December 15, 1985, A enters into a non-section 1256 position that is offsetting to the non-section 1256 gain position of the section 1092(b)(2) identified mixed straddle. At year-end there is $200 of unrecognized gain in the non-section 1256 position that was entered into on December 15. Under these circumstances, the $2,200 loss on the section 1256 contract will be offset against the $2,000 gain on the non-section 1256 position. The net $200 loss from the straddle will be treated as 60 percent long-term capital loss and 40 percent short-term capital loss because it is attributable to the section 1256 contract. The net loss of $200 from the straddle will be disallowed in 1985 under the loss deferral rules of section 1092(a) because there is $200 of unrecognized gain in a successor position (as defined in paragraph (n) of §1.1092(b)–5T) at year-end. See paragraph (c) of this section.

(3) *All of the non-section 1256 positions of a section 1092(b)(2) identified mixed straddle disposed of on the same day.* This paragraph (b)(3) applies if all of the non-section 1256 positions of a section 1092(b)(2) identified mixed straddle are disposed of on the same day or if this paragraph (b)(3) is made applicable by paragraph (b)(5) of this section. In the case to which this paragraph (b)(3) applies, gain and loss realized from non-section 1256 positions shall be netted. Realized and unrealized gain and loss with respect to the section 1256 contracts of the straddle also shall be netted on that day. Realized net gain or loss from the non-section 1256 positions shall then be offset against net gain or loss from the section 1256 contracts to determine the net gain or loss from the straddle on that day. Net gain or loss from the straddle that is attributable to the non-section 1256 positions shall be realized and treated as short-term capital gain or loss on that day. Net gain or loss from the straddle that is attributable to realized gain or loss with respect to section 1256 contracts shall be realized and treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. Any gain or loss subsequently realized on the section 1256 contracts shall be adjusted (through an adjustment to basis or otherwise) to take into account the extent to which gain or loss was offset by unrealized gain or loss on the section 1256 contracts on that day. This paragraph (b)(3) may be illustrated by the following examples. It is assumed in each example that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year.

Example 1. On July 20, 1985, A enters into a section 1256 contract and an offsetting non-section 1256 position and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On July 27, 1985, A disposes of the non-section 1256 position at a $1,500 loss, at which time there is $1,500 of unrealized gain in the section 1256 contract. A holds the section 1256 contract at year-end at which time there is $1,800 of gain. Under these circumstances, on July 27, 1985, A offsets the $1,500 loss on the non-section 1256 position against the $1,500 gain on the section 1256 contract and realizes no gain or loss. On December 31, 1985, A realizes a $300 gain on the section 1256 contract because the position is deemed disposed of under section 1256(a)(1). The $300 gain is equal to $1,800 of gain less a $1,500 adjustment for unrealized gain offset against the

loss realized on the non-section 1256 position on July 27, 1985, and the gain will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain.

Example 2. Assume the facts are the same as in example (1), except that on July 27, 1985, A realized a $1,700 loss on the non-section 1256 position. Under these circumstances, on July 27, 1985, A offsets the $1,700 loss on the non-section 1256 position against the $1,500 gain on the section 1256 contract. A realizes a $200 loss from the straddle on July 27, 1985, which will be treated as short-term capital loss because it is attributable to the non-section 1256 position. On December 31, 1985, A realizes a $300 gain on the section 1256 contract, computed as in example (1), which will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain.

Example 3. On March 1, 1985, A enters into a straddle consisting of two non-section 1256 positions and two section 1256 contracts and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On March 11, 1985, A disposes of the non-section 1256 positions, one at a $100 loss and the other at a $150 loss, and disposes of one section 1256 contract at a $100 loss. On that day there is $100 of unrealized gain on the section 1256 contract retained by A. A holds the remaining section 1256 contract at year-end, at which time there is $150 of gain. Under these circumstances, on March 11, 1985, A will first net the gains and losses from the section 1256 contracts and net the gains and losses from the non-section 1256 positions resulting in no gain or loss on the section 1256 contracts and a net loss of $250 on the non-section 1256 positions. Since there is no gain or loss to offset against the non-section 1256 positions, the net loss of $250 will be treated as short-term capital loss because it is attributable to the non-section 1256 positions. On December 31, 1985, A realizes a $50 gain on the remaining section 1256 contract because the position is deemed disposed of under section 1256(a)(1). The $50 gain is equal to $150 gain less a $100 adjustment to take into account the $100 unrealized gain that was offset against the $100 loss realized on the section 1256 contract on March 11, 1985.

Example 4. Assume the facts are the same as in example (3), except that A disposes of the section 1256 contract at a $500 gain. As in example (3), A has a net loss of $250 on the non-section 1256 positions disposed of. In this example, however, A has net gain of $600 ($500 + $100) on the section 1256 contracts on March 11, 1985. Therefore, of the net gain from the straddle of $350 ($600–$250), $250 ($500–$250) is treated as 60 percent long-term capital gain and 40 percent short-term capital gain because only $250 is attributable to the realized gain from the section 1256 contract. In addition, because none of the $100 unrealized gain from the remaining section 1256 contract was offset against gain or loss on the non-section 1256 positions, no adjustment is made under paragraph (b)(3) of this section and the entire $150 gain on December 31 with respect to that contract is realized on that date.

(4) *All of the section 1256 contracts of a section 1092(b)(2) identified mixed straddle disposed of on the same day.* This paragraph (b)(4) applies if all of the section 1256 contracts of a section 1092(b)(2) identified mixed straddle are disposed of (or deemed disposed of) on the same day or if this paragraph (b)(4) is made applicable by paragraph (b)(5) of this section. In the case to which this paragraph (b)(4) applies, gain and loss realized from section 1256 contracts shall be netted. Realized and unrealized gain and loss with respect to the non-section 1256 positions of the straddle also shall be netted on that day. Realized net gain or loss from the section 1256 contracts shall be treated as short-term capital gain or loss to the extent of net gain or loss on the non-section 1256 positions on that day. Net gain or loss with respect to the section 1256 contracts that exceeds the net gain or loss with respect to the non-section 1256 positions of the straddle shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. See paragraph (b)(7) of this section relating to the gain or loss on such non-section 1256 positions. This paragraph (b)(4) may be illustrated by the following examples. It is assumed in each example that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year.

Example 1. On December 30, 1985, A enters into a section 1256 contract and an offsetting non-section 1256 position and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On December 31, 1985, A disposes of the section 1256 contract at a $1,000 gain, at which time there is $1,000 of unrealized loss in the non-section 1256 position. Under these circumstances, the $1,000 gain realized on the section 1256 contract will be treated as short-term capital gain because there is a $1,000 loss on the non-section 1256 position.

Example 2. Assume the facts are the same as in example (1), except that A realized a $1,500 gain on the disposition of the section

1256 contract. Under these circumstances, $1,000 of the gain realized on the section 1256 contract will be treated as short-term capital gain because there is a $1,000 loss on the non-section 1256 position. The net gain of $500 from the straddle will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain because it is attributable to the section 1256 contract.

Example 3. Assume the facts are the same as in example (1), except that A realized a $1,000 loss on the section 1256 contract and there is $1,000 of unrecognized gain on the non-section 1256 position. Under these circumstances, the $1,000 loss on the section 1256 contract will be treated as short-term capital loss because there is a $1,000 gain on the non-section 1256 position. Such loss, however, will be disallowed in 1985 under the loss deferral rules of section 1092(a) because there is $1,000 of unrecognized gain in an offsetting position at year-end. See paragraph (c) of this section.

Example 4. Assume the facts are the same as in example (1), except that the section 1256 contract and non-section 1256 position were entered into on December 1, 1985, and the section 1256 contract is disposed of on December 19, 1985, for a $1,000 gain, at which time there is $1,000 of unrealized loss on the non-section 1256 position. At year-end there is only $800 of unrealized loss in the non-section 1256 position. Under these circumstances, the result is the same as in example (1) because there was $1,000 of unrealized loss on the non-section 1256 position at the time of the disposition of the section 1256 contract.

Example 5. On July 15, 1985, A enters into a straddle consisting of two non-section 1256 positions and two section 1256 contracts and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On July 20, 1985, A disposes of one non-section 1256 position at a gain of $1,000 and both section 1256 contracts at a net loss of $1,000. On the same day there is $200 of unrealized loss on the non-section 1256 position retained by A. Under these circumstances, realized and unrealized gain and loss with respect to the non-section 1256 positions is netted, resulting in a net gain of $800. Thus, $800 of the net loss on the section 1256 contracts disposed of will be treated as short-term capital loss because there is $800 of net gain on the non-section 1256 positions. In addition, the net loss of $200 from the straddle will be treated as 60 percent long-term capital loss and 40 percent short-term capital loss because it is attributable to the section 1256 contract.

(5) *Disposition of one or more, but not all, positions of a section 1092(b)(2) identified mixed straddle on the same day.* If one or more, but not all, of the positions of a section 1092(b)(2) identified mixed straddle are disposed of on the same day, and paragraphs (b) (3) and (4) of this section are not applicable (without regard to this paragraph (b)(5)), the gain and loss from the non-section 1256 positions that are disposed of on that day shall be netted, and the gain and loss from the section 1256 contracts that are disposed of on that day shall be netted. In order to determine whether the rules of paragraph (b)(3) or (b)(4) of this section apply, net gain or loss from the section 1256 contracts disposed of shall then be offset against net gain or loss from the non-section 1256 positions disposed of to determine net gain or loss from such positions of the straddle. If net gain or loss from the disposition of such positions of the straddle is attributable to the non-section 1256 positions disposed of, the rules prescribed in paragraph (b)(3) of this section apply. If net gain or loss from the disposition of such positions is attributable to the section 1256 contracts disposed of, the rules prescribed in paragraph (b)(4) of this section apply. If the net gain or loss from the netting of non-section 1256 positions disposed of and the netting of section 1256 contracts disposed of are either both gains or losses, the rules prescribed in paragraph (b)(3) of this section shall apply to net gain or loss from such non-section 1256 positions, and the rules prescribed in paragraph (b)(4) of this section shall apply to net gain or loss from such section 1256 contracts. However, for purposes of determining the treatment of gain or loss subsequently realized on a position of such straddle, to the extent that unrealized gain or loss on other positions was used to offset realized gain or loss on a non-section 1256 position under paragraph (b)(3) of this section, or was used to treat realized gain or loss on a section 1256 contract as short-term capital gain or loss under paragraph (b)(4) of this section, such amount shall not be used for such purposes again. This paragraph (b)(5) may be illustrated by the following examples. It is assumed that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year.

Example 1. On July 15, 1985, A enters into a straddle consisting of four non-section 1256 positions and four section 1256 contracts and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On July 20, 1985, A disposes of one non-section 1256 position at a gain of $800 and one section 1256 contract at a loss of $300. On the same day there is $400 of unrealized net loss on the section 1256 contracts retained by A and $100 of unrealized net loss on the non-section 1256 positions retained by A. Under these circumstances, the loss of $300 on the section 1256 contract disposed of will be offset against the gain of $800 on the non-section 1256 position disposed of. The net gain of $500 is attributable to the non-section 1256 position. Therefore, the rules of paragraph (b)(3) of this section apply. Under the rules of paragraph (b)(3) of this section, the net loss of $700 on the section 1256 contracts is offset against the net gain of $800 attributable to the non-section 1256 position disposed of. The net gain of $100 will be treated as short-term capital gain because it is attributable to the non-section 1256 position disposed of. Gain or loss subsequently realized on the section 1256 contracts will be adjusted to take into account the unrealized loss of $400 that was offset against the $800 gain attributable to the non-section 1256 position disposed of.

Example 2. Assume the facts are the same as in Example 1, except that A disposes of the non-section 1256 position at a gain of $300 and the section 1256 contract at a loss of $800, and there is $200 of unrealized net gain in the non-section 1256 positions retained by A. Under these circumstances, the gain of $300 on the non-section 1256 position disposed of will be offset against the loss of $800 on the section 1256 contract disposed of. The net loss of $500 is attributable to the section 1256 contract. Therefore, the rules of paragraph (b)(4) of this section apply. Under the rules of paragraph (b)(4) of this section, $500 of the net loss realized on the section 1256 contract will be treated as short-term capital loss because there is $500 of realized and unrealized gain in the non-section 1256 positions. The remaining net loss of $300 will be treated as 60 percent long-term capital loss and 40 percent short-term capital loss because it is attributable to a section 1256 contract disposed of. In addition, A realizes a $300 short-term capital gain attributable to the disposition of the non-section 1256 position.

Example 3. (i) Assume the facts are the same as in example (1), except that the section 1256 contract was disposed of at a $500 gain. Under these circumstances, there is gain of $500 attributable to the section 1256 contact disposed of and a gain of $800 attributable to the non-section 1256 position. Therefore, the rules of both paragraphs (b)(3) and (4) of this § 1.1092(b)–3T apply.

(ii) Under paragraph (b)(3) of this section, the realized and unrealized gains and losses on the section 1256 contracts are netted, resulting in a net gain of $100 ($500–$400). The section 1256 contract net gain does not offset the gain on the non-section 1256 position disposed of. Therefore, the gain of $800 on the non-section 1256 position disposed of will be treated as a short-term capital gain because there is no net loss on the section 1256 contracts.

(iii) Under paragraph (b)(4) of this section, the realized and unrealized gains and losses on the non-section 1256 positions are netted, resulting in a non-section 1256 position net gain of $700 ($800–$100). Because there is no net loss on the non-section 1256 positions, the $500 gain realized on the section 1256 contract will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain.

(6) *Accrued gain and loss with respect to positions of a section 1092(b)(2) identified mixed straddle established on or before August 18, 2014.* The rules of this paragraph (b)(6) apply to all section 1092(b)(2) identified mixed straddles established on or before *August 18, 2014*; see § 1.1092(b)–6 for section 1092(b)(2) identified mixed straddles established after August 18, 2014. If one or more positions of a section 1092(b)(2) identified mixed straddle were held by the taxpayer on the day prior to the day the section 1092(b)(2) identified mixed straddle is established, such position or positions shall be deemed sold for their fair market value as of the close of the last business day preceding the day such straddle is established. See §§ 1.1092(b)–1T and 1.1092(b)–2T for application of the loss deferral and wash sale rules and for treatment of holding periods and losses with respect to such positions. An adjustment (through an adjustment to basis or otherwise) shall be made to any subsequent gain or loss realized with respect to such to such position or positions for any gain or loss recognized under this paragraph (b)(6). This paragraph (b)(6) may be illustrated by the following examples. It is assumed in each example that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year.

Example 1. On January 1, 1985, A enters into a non-section 1256 position. As of the close of the day on July 9, 1985, there is $500 of unrealized long-term capital gain in the non-section 1256 position. On July 10, 1985, A enters

into an offsetting section 1256 contract and makes a valid election to treat the straddle as a section 1092(b)(2) identified mixed straddle. Under these circumstances, on July 9, 1985, A will recognize $500 of long-term capital gain on the non-section 1256 position.

Example 2. On February 1, 1985, A enters into a section 1256 contract. As of the close of the day on February 4, 1985, there is $500 of unrealized gain on the section 1256 contract. On February 5, 1985, A enters into an offsetting non-section 1256 position and makes a valid election to treat the straddle as a section 1092(b)(2) identified mixed straddle. Under these circumstances, on February 4, 1985, A will recognize a $500 gain on the section 1256 contract, which will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain.

Example 3. Assume the facts are the same as in example (2) and that on February 10, 1985, there is $2,000 of unrealized gain in the section 1256 contract. A disposes of the section 1256 contract at a $2,000 gain and disposes of the offsetting non-section 1256 position at a $1,000 loss. Under these circumstances, the $2,000 gain on the section 1256 contract will be reduced to $1,500 to take into account the $500 gain recognized when the section 1092(b)(2) identified mixed straddle was established. The $1,500 gain on the section 1256 contract will be offset against the $1,000 loss on the non-section 1256 position. The net $500 gain from the straddle will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain because it is attributable to the section 1256 contract.

Example 4. On March 1, 1985, A enters into a non-section 1256 position. As of the close of the day on March 2, 1985, there is $400 of unrealized short-term capital gain in the non-section 1256 position. On March 3, 1985, A enters into an offsetting section 1256 contract and makes a valid election to treat the straddle as a section 1092(b)(2) identified mixed straddle. On March 10, 1985, A disposes of the section 1256 contract at a $500 loss and the non-section 1256 position at a $500 gain. Under these circumstances, on March 2, 1985, A will recognize $400 of short-term capital gain attributable to the gain accrued on the non-section 1256 position prior to the day the section 1092(b)(2) identified mixed straddle was established. On March 10, 1985, the gain of $500 on the non-section 1256 position will be reduced to $100 to take into account the $400 of gain recognized when the section 1092(b)(2) identified mixed straddle was established. The $100 gain on the non-section 1256 position will be offset against the $500 loss on the section 1256 contract. The net loss of $400 from the straddle will be treated as 60 percent long-term capital loss and 40 percent short-term capital loss because it is attributable to the section 1256 contract.

(7) *Treatment of gain and loss from non-section 1256 positions after disposition of all section 1256 contracts.* Gain or loss on a non-section 1256 position that is part of a section 1092(b)(2) identified mixed straddle and that is held after all section 1256 contracts in the straddle are disposed of shall be treated as short-term capital gain or loss to the extent attributable to the period when the positions were part of such straddle. See § 1.1092(b)–2T for rules concerning the holding period of such positions. This paragraph (b)(7) may be illustrated by the following example. It is assumed that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) during the taxable years.

Example: On December 1, 1985, A, an individual calendar year taxpayer, enters into a section 1256 contract and an offsetting non-section 1256 position and makes a valid election to treat such straddle as a section 1092(b)(2) identified mixed straddle. On December 31, 1985, A disposes of the section 1256 contract at a $1,000 loss. On the same day, there is $1,000 of unrecognized gain in the non-section 1256 position. The $1,000 loss on the section 1256 contract is treated as short-term capital loss because there is a $1,000 gain on the non-section 1256 position, but the $1,000 loss is disallowed in 1985 because there is $1,000 of unrecognized gain in the offsetting nonsection 1256 position. See section 1092(a) and § 1.1092(b)–1T. On July 10, 1986, A disposes of the non-section 1256 position at a $1,500 gain, $500 of which is attributable to the post-straddle period. Under these circumstances, $1,000 of the gain on the non-section 1256 position will be treated as short-term capital gain because that amount of the gain is attributable to the period when the position was part of a section 1092(b)(2) identified mixed straddle. The remaining $500 of the gain will be treated as long-term capital gain because the position was held for more than six months after the straddle was terminated. In addition, the $1,000 short-term capital loss disallowed in 1985 will be taken into account at this time.

(c) *Coordination with loss deferral and wash sale rules of § 1.1092(b)–1T.* This section shall apply prior to the application of the loss deferral and wash sale rules of § 1.1092(b)–1T.

(d) *Identification required*—(1) *In general.* To elect the provisions of this section, a taxpayer must clearly identify on a reasonable and consistently applied economic basis each position that

is part of the section 1092(b)(2) identified mixed straddle before the close of the day on which the section 1092(b)(2) identified mixed straddle is established. If the taxpayer disposes of a position that is part of a section 1092(b)(2) identified mixed straddle before the close of the day on which the straddle is established, such identification must be made at or before the time that the taxpayer disposes of the position. In the case of a taxpayer who is an individual, the close of the day is midnight (local time) in the location of the taxpayer's principal residence. In the case of all other taxpayers, the close of the day is midnight (local time) in the location of the taxpayer's principal place of business. Only the person or entity that directly holds all positions of a straddle may make the election under this section.

(2) *Presumptions*. A taxpayer is presumed to have identified a section 1092(b)(2) identified mixed straddle by the time prescribed in paragraph (d)(1) of this section if the taxpayer receives independent verification of the identification (within the meaning of paragraph (d)(4) of this section). The presumption referred to in this paragraph (d)(2) may be rebutted by clear and convincing evidence to the contrary.

(3) *Corroborating evidence*. If the presumption of paragraph (d)(2) of this section does not apply, the burden shall be on the taxpayer to establish that an election under paragraph (d)(1) of this section was made by the time specified in paragraph (d)(1) of this section. If the taxpayer has no evidence of the time when the identification required by paragraph (d)(1) of this section is made, other than the taxpayer's own testimony, the election is invalid unless the taxpayer shows good cause for failure to have evidence other than the taxpayer's own testimony.

(4) *Independent verification*. For purposes of this section, the following constitute independent verification:

(i) *Separate account*. Placement of one or more positions of a section 1092(b)(2) identified mixed straddle in a separate account designated as a *section 1092(b)(2) identified mixed straddle account* that is maintained by a broker (as defined in §1.6045–1(a)(1)), futures commission merchant (as defined in 7 U.S.C. 2 and 17 CFR 1.3(p)), or similar person and in which notations are made by such person identifying all positions of the section 1092(b)(2) identified mixed straddle and stating the date the straddle is established.

(ii) *Confirmation*. A written confirmation from a person referred to in paragraph (d)(4)(i) of this section, or from the party from which one or more positions of the section 1092(b)(2) identified mixed straddle are acquired, stating the date the straddle is established and identifying the other positions of the straddle.

(iii) *Other methods*. Such other methods of independent verification as the Commissioner may approve at the Commissioner's discretion.

(5) *Section 1092 (b)(2) identified mixed straddles established before February 25, 1985*. Notwithstanding the provisions of paragraph (d)(1) of this section, relating to the time of identification of a section 1092(b)(2) identified mixed straddle, a taxpayer may identify straddles that were established before February 25, 1985 as section 1092(b)(2) identified mixed straddles after the time specified in paragraph (d)(1) of this section if the taxpayer adopts a reasonable and consistent economic basis for identifying the positions of such straddles.

(e) *Effective date*—(1) *In general*. The provisions of this section shall apply to straddles established on or after January 1, 1984.

(2) *Pre-1984 accrued gain*. If the last business day referred to in paragraph (b)(6) of this section is contained in a period to which paragraph (b)(6) does not apply, the gains and losses from the deemed sale shall be included in the first period to which paragraph (b)(6) applies.

(Secs. 1092(b)(1), 1092(b)(2) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 98 Stat. 627; 26 U.S.C. 1092(b)(1), 1092(b)(2), 7805))

[T.D. 8008, 50 FR 3325, Jan. 24, 1985; 50 FR 12243, Mar. 28, 1985; 50 FR 19344, May 8, 1985; T.D. 9627, 78 FR 46808, Aug. 2, 2013; 78 FR 64397, Oct. 29, 2013; T.D. 9678, 79 FR 41888, July 18, 2014]

§ 1.1092(b)–4T Mixed straddles; mixed straddle account (temporary).

(a) *In general*. A taxpayer may elect (in accordance with paragraph (f) of

this section) to establish one or more mixed straddle accounts (as defined in paragraph (b) of this section). Gains and losses from positions includible in a mixed straddle account shall be determined and treated in accordance with the rules set forth in paragraph (c) of this section. A mixed straddle account is treated as established as of the first day of the taxable year for which the taxpayer makes the election or January 1, 1984, whichever is later. See § 1.1092(b)–5T relating to definitions.

(b) *Mixed straddle account defined*—(1) *In general.* The term *mixed straddle account* means an account for determining gains and losses from all positions held as capital assets in a designated class of activities by the taxpayer at the time the taxpayer elects to establish a mixed straddle account. A separate mixed straddle account must be established for each separate designated class of activities.

(2) *Permissible designations.* Except as otherwise provided in this section, a taxpayer may designate as a class of activities the types of positions that a reasonable person, on the basis of all the facts and circumstances, would ordinarily expect to be offsetting positions. This paragraph (b)(2) may be illustrated by the following example. It is assumed in the example that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) during the taxable year, and that gain or loss from the positions is treated as gain or loss from a capital asset.

Example: B engages in transactions in dealer equity options on XYZ Corporation stock, stock in XYZ Corporation, dealer equity options on UVW Corporation stock, and stock in UVW Corporation. A reasonable person, on the basis of all the facts and circumstances, would not expect dealer equity options on XYZ Corporation stock and stock in XYZ Corporation to offset any dealer equity options on UVW Corporation stock or any stock in UVW Corporation. If B makes the mixed straddle account election under this section for all such positions, B must designate two separate classes of activities, one consisting of transactions in dealer equity options on XYZ Corporation stock and stock in XYZ Corporation, and the other consisting of transactions in dealer equity options on UVW Corporation stock and stock in UVW Corporation, and maintain two separate mixed straddle accounts.

(3) *Positions that offset positions in more than one mixed straddle account.* Gains and losses from positions that a reasonable person, on the basis of all the facts and circumstances, ordinarily would expect to be offsetting with respect to positions in more than one mixed straddle account shall be allocated among such accounts under a reasonable and consistent method that clearly reflects income. This paragraph (b)(2) may be illustrated by the following example. It is assumed that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) during the taxable year, and that gain or loss from the positions is treated as gain or loss from a capital asset.

Example: B holds stock in XYZ Corporation, UVW Corporation, and RST Corporation, and options on a broad based stock index future. A reasonable person, on the basis of all the facts and circumstances, would expect the stock in XYZ Corporation, UVW Corporation, and RST Corporation to be offsetting positions with respect to the options on the broad based stock index future. A reasonable person, on the basis of all the facts and circumstances, would not expect that stock in XYZ Corporation, UVW Corporation, or RST Corporation would be offsetting positions with respect to each other. If B makes the mixed straddle account election under this section for all such positions, B must designate three separate classes of activities: one consisting of stock in XYZ Corporation; one consisting of stock in UVW Corporation; and one consisting of stock in RST Corporation, and maintain three separate mixed straddle accounts. Options on the broad based stock index future must be designated as part of all three classes of activities and gains and losses from such options must be allocated among such accounts under a reasonable and consistent method that clearly reflects income, because such options are a type of position expected to be offsetting with respect to the positions in all three mixed straddle accounts.

(4) *Impermissible designations*—(i) *Types of positions that are not offsetting included in designated class of activities.* If the Commissioner determines, on the basis of all the facts and circumstances, that a class of activities designated by a taxpayer includes types of positions that a reasonable person, on the basis of all the facts and circumstances, ordinarily would not expect to be offsetting positions with

respect to other types of positions in the account, the Commissioner may—

(A) Amend the class of activities designated by the taxpayer and remove positions from the account that are not within the amended designated class of activities; or

(B) Amend the class of activities designated by the taxpayer to establish two or more mixed straddle accounts.

(ii) *Types of positions that are offsetting not included in designated class of activities.* If the Commissioner determines, on the basis of all the facts and circumstances, that a designated class of activities does not include types of positions that are offsetting with respect to types of positions within the designated class, the Commissioner may—

(A) Amend the class of activities designated by the taxpayer to include types of positions that are offsetting with respect to the types of positions within the designated class and place such positions in the account; or

(B) Amend the class of activities designated by the taxpayer to exclude types of positions that are offsetting with respect to the types of positions that are not in the account.

(iii) *Treatment of positions removed from or included in the account.* (A) Positions removed from a mixed straddle account will be subject to the rules of taxation generally applicable to such positions. Thus, for example, if the positions removed from the account are offsetting positions with respect to other positions outside the account, the rules of §§1.1092(b)–1T and 1.1092(b)–2T apply.

(B) If the taxpayer acted consistently and in good faith in designating the class of activities of the account and in placing positions in the account, the rules of §1.1092(b)–2T(b)(2) shall not apply to any mixed straddles resulting from the removal of such positions from the account and the Commissioner, at the Commissioner's discretion, may identify such mixed straddles as section 1092(b)(2) identified mixed straddles and apply the rules of §1.1092(b)–3T(b) to such straddles.

(C) If positions are placed in a mixed straddle account, such positions shall be treated as if they were originally included in the mixed straddle account in which they are placed.

(5) *Positions included in a mixed straddle account that are not within the designated class of activities.* The Commissioner may remove one or more positions from a mixed straddle account if, on the basis of all the facts and circumstances, the Commissioner determines that such positions are not within the designated class of activities of the account. See paragraph (b)(4)(iii) of this section for rules concerning the treatment of such positions.

(6) *Positions outside a mixed straddle account that are within the designated class of activities.* If a taxpayer holds types of positions outside of a mixed straddle account (including positions in another mixed straddle account) that are within the designated class of activities of a mixed straddle account, the Commissioner may require the taxpayer to include such types of positions in the mixed straddle account, move positions from one account to another, or remove from the mixed straddle account types of positions that are offsetting with respect to the types of positions held outside the account. See paragraph (b)(4)(iii) of this section for the treatment of such positions.

(c) *Treatment of gains and losses from positions in a mixed straddle account*—(1) *Daily account net gain or loss.* Except as provided in paragraphs (d) and (e) of this section (relating to positions in a mixed straddle account before January 1, 1985) as of the close of each business day of the taxable year, gain or loss shall be determined for each position in a mixed straddle account that is disposed of during the day. Positions in a mixed straddle account that have not been disposed of as of the close of the day shall be treated as if sold for their fair market value at the close of each business day. Gains and losses for each business day from non-section 1256 positions in each mixed straddle account shall be netted to determine *net non-section 1256 position gain or loss* for the account, and gains and losses for each business day from section 1256 contracts in each mixed straddle account shall be netted to determine *net section 1256 contract gain or loss* for the account. Net non-section 1256 position gain or loss from the account is then

offset against net section 1256 contract gain or loss from the same mixed straddle account to determine the *daily account net gain or loss* for the account. If daily account net gain or loss is attributable to the net non-section 1256 position gain or loss, daily account net gain or loss for such account shall be treated as short-term capital gain or loss. If daily account net gain or loss is attributable to the net section 1256 contract gain or loss, daily account net gain or loss for such account shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. If net non-section 1256 position gain or loss and net section 1256 contract gain or loss are either both gains or both losses, that portion of the daily account net gain or loss attributable to net non-section 1256 position gain or loss shall be treated as short-term capital gain or loss and that portion of the daily account net gain or loss attributable to net section 1256 contract gain or loss shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. An adjustment (through an adjustment to basis or otherwise) shall be made to any subsequent gain or loss determined under this paragraph (c)(1) to take into account any gain or loss determined for prior business days under this paragraph (c)(1).

(2) *Annual account net gain or loss; total annual account net gain or loss.* On the last business day of the taxable year, the *annual account net gain or loss* for each mixed straddle account established by the taxpayer shall be determined by netting the daily account net gain or loss for each business day in the taxable year for each account. Annual account net gain or loss for each mixed straddle account shall be adjusted pursuant to paragraph (c)(3) of this section. The *total annual account net gain or loss* shall be determined by netting the annual account net gain or loss for all mixed straddle accounts established by the taxpayer, as adjusted pursuant to paragraph (c)(3) of this section. Total annual account net gain or loss is subject to the limitations of paragraph (c)(4) of this section. See paragraphs (d) and (e) of this section for determining the annual account net gain or loss for mixed straddle accounts established for taxable years beginning before January 1, 1985.

(3) *Application of section 263(g) to mixed straddle accounts.* No deduction shall be allowed for interest and carrying charges (as defined in section 263(g)(2)) properly allocable to a mixed straddle account. Interest and carrying charges properly allocable to a mixed straddle account means the excess of—

(i) The sum of—

(A) Interest on indebtedness incurred or continued during the taxable year to purchase or carry any position in the account; and

(B) All other amounts (including charges to insure, store or transport the personal property) paid or incurred to carry any position in the account; over

(ii) The sum of—

(A) The amount of interest (including original issue discount) includible in gross income for the taxable year with respect to all positions in the account;

(B) Any amount treated as ordinary income under section 1271(a)(3)(A), 1278, or 1281(a) with respect to any position in the account for the taxable year; and

(C) The excess of any dividends includible in gross income with respect to positions in the account for the taxable year over the amount of any deduction allowable with respect to such dividends under section 243, 244, or 245.

For purposes of paragraph (c)(3)(i) of this section, the term *interest* includes any amount paid or incurred in connection with positions in the account used in a short sale. Any interest and carrying charges disallowed under this paragraph (c)(3) shall be capitalized by treating such charges as an adjustment to the annual account net gain or loss and shall be allocated pro rata between net short-term capital gain or loss and net long-term capital gain or loss.

(4) *Limitation on total annual account net gain or loss.* No more than 50 percent of total annual account net gain for the taxable year shall be treated as long-term capital gain. Any long-term capital gain in excess of the 50 percent limit shall be treated as short-term capital gain. No more than 40 percent of total annual account net loss for the taxable year shall be treated as short-

term capital loss. Any short-term capital loss in excess of the 40 percent limit shall be treated as long-term capital loss.

(5) *Accrued gain and loss with respect to positions includible in a mixed straddle account.* Positions includable in a mixed straddle account that are held by a taxpayer on the day prior to the day the mixed straddle account is established shall be deemed sold for their fair market value as of the close of the last business day preceding the day such mixed straddle account is established. See §§ 1.1092(b)–1T and 1.1092(b)–2T for application of the loss deferral and wash sale rules and for treatment of holding periods and losses with respect to such positions. An adjustment (through an adjustment to basis or otherwise) shall be made to any subsequent gain or loss realized with respect to such positions for any gain or loss recognized under this paragraph (c)(5).

(6) *Examples.* This paragraph (c) may be illustrated by the following examples. It is assumed in each example that the positions are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year, and that gain or loss from the positions is treated as gain or loss from a capital asset.

Example 1. A establishes a mixed straddle account for a class of activities consisting of transactions in stock of XYZ Corporation and dealer equity options on XYZ Corporation stock. Assume that A enters into no transactions in XYZ Corporation stock or dealer equity options on XYZ Corporation stock prior to December 26, 1985. Thus, the net non-section 1256 position gain or loss and the net section 1256 contract gain or loss for the account are zero for each business day except the following days:

	Net non-section 1256 position gain or loss (XYZ corporation stock)	Net section 1256 contract gain or loss (XYZ corporation dealer equity options)
December 26, 1985	$1,000	$20,000
December 27, 1985	(9,000)	3,000
December 30, 1985	(5,000)	15,000
December 31, 1985	7,000	(2,000)

The daily account net gain or loss is as follows:

	Daily account net gain or loss	Treatment of daily account net gain or loss	Long-term	Short-term
December 26, 1985 ..	$21,000	$1,000 short-term capital gain, $20,000 60 percent long-term capital gain and 40 percent short-term capital gain.	$12,000	$9,000
December 27, 1985 ..	(6,000)	Short-term capital loss	.....	(6,000)
December 30, 1985 ..	10,000	60 percent long-term capital gain and 40 percent short-term capital gain.	6,000	4,000
December 31, 1985 ..	5,000	Short-term capital gain	.....	5,000

The annual account net gain or loss is $18,000 of long-term capital gain and $12,000 of short-term capital gain. Because A has no other mixed straddle accounts, total annual account net gain or loss is also $18,000 long-term capital gain and $12,000 short-term capital gain. Because more than 50 percent of the total annual account net gain is long-term capital gain, $3,000 of the $18,000 long-term capital gain will be treated as short-term capital gain.

Example 2. Assume the facts are the same as in example (1), except that interest and carrying charges in the amount of $6,000 are allocable to the mixed straddle account and are capitalized under paragraph (c)(3) of this section. Under these circumstances, $3,600 (($18,000/$30,000) × $6,000) of the interest and carrying charges will reduce the $18,000 long-term capital gain to $14,400 long-term capital gain and $2,400 (($12,000/$30,000) × $6,000) of the interest and carrying charges will reduce the $12,000 short-term capital gain to $9,600 short-term capital gain. Because more than 50 percent of the total annual account net gain is long-term capital gain, $2,400 of the $14,400 long-term capital gain will be treated as short-term capital gain.

Example 3. Assume the facts are the same as in example (1), except that A has a second mixed straddle account, which has an annual account net loss of $14,000 of long-term capital loss and $6,000 of short-term capital loss. Under these circumstances, the total annual account net gain is $4,000 ($18,000 − $14,000) of long-term capital gain and $6,000 ($12,000 − $6,000) of short-term capital gain. Because not more than 50 percent of the total annual account net gain is long-term capital gain, none of the long-term capital gain will be treated as short-term capital gain.

Example 4. Assume the facts are the same as in example (3), except that interest and carrying charges in the amount of $4,000 are

allocable to the second mixed straddle account and are capitalized under paragraph (c)(3) of this section. Under these circumstances, $2,800 (($14,000/$20,000) × $4,000)) of the interest and carrying charges will increase the $14,000 long-term capital loss to $16,800 of long-term capital loss and $1,200 (($6,000/$20,000) × $4,000)) of the interest and carrying charges will increase the $6,000 short-term capital loss to $7,200 short-term capital loss. The total annual account net gain is $1,200 of long-term capital gain ($18,000 $16,800) and $4,800 ($12,000 − $7,200) of short-term capital gain. Because not more than 50 percent of the total annual account net gain is long-term capital gain, none of the $1,200 long-term capital gain will be treated as short-term capital gain.

Example 5. Assume the facts are the same as in example (1), except that A has a second mixed straddle account, which has an annual account net loss of $20,000 of long-term capital loss and $15,000 of short-term capital loss. Under these circumstances, the total annual account net loss is $2,000 ($20,000 − $18,000) of long-term capital loss and $3,000 ($15,000 − $12,000) of short-term capital loss. Because more than 40 percent of the total annual account net loss is short-term capital loss, $1,000 of the short-term capital loss will be treated as long-term capital loss.

Example 6. A establishes two mixed straddle accounts. Account 1 has an annual account net gain of $5,000 short-term capital gain, which results from netting $5,000 of long-term capital loss and $10,000 of short-term capital gain. Account 2 has an annual account net loss of $2,000 long-term capital loss, which results from netting $3,000 of long-term capital loss against $1,000 of short-term capital gain. The total annual account net gain is $3,000 short-term capital gain, which results from netting the annual account net gain of $5,000 short-term capital gain from Account 1 against the annual account net loss of $2,000 long-term capital loss from Account 2.

(d) *Treatment of gains and losses from positions in a mixed straddle account established on or before December 31, 1984, in taxable years ending after December 31, 1984; pre-1985 account net gain or loss.* For mixed straddle accounts established on or before December 31, 1984, in taxable years ending after December 31, 1984, the taxpayer on December 31, 1984, shall determine gain or loss for each position in the mixed straddle account that has been disposed of on any day during the period beginning on the first day of the taxpayer's taxable year that includes December 31, 1984, and ending on December 31, 1984. Positions in the mixed straddle account that have not been disposed of as of the close of December 31, 1984, shall be treated as if sold for their fair market value as of the close of December 31, 1984. Gains and losses for such period from non-section 1256 positions in each mixed straddle account shall be netted to determine *pre-1985 net non-section 1256 position gain or loss* and gains and losses for such period from section 1256 contracts in each mixed straddle account shall be netted to determine *pre-1985 net section 1256 contract gain or loss.* Pre-1985 net non-section 1256 position gain or loss is then offset against pre-1985 net section 1256 contract gain or loss from the same mixed straddle account to determine the *pre-1985 account net gain or loss* for the period. If the pre-1985 account net gain or loss is attributable to pre-1985 net non-section 1256 position gain or loss, the pre-1985 account net gain or loss from such account shall be treated as short-term capital gain or loss. If the pre-1985 account net gain or loss is attributable to pre-1985 net section 1256 contract gain or loss, the pre-1985 account net gain or loss from such account shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. If pre-1985 net non-section 1256 position gain or loss and pre-1985 net section 1256 contract gain or loss are either both gains or losses, that portion of the pre-1985 account net gain or loss attributable to pre-1985 net non-section 1256 position gain or loss shall be treated as short-term capital gain or loss and that portion of the pre-1985 account net gain or loss attributable to pre-1985 net section 1256 contract gain or loss shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. An adjustment (through an adjustment to basis or otherwise) shall be made to any subsequent gain or loss realized with respect to such positions for any gain or loss recognized under this paragraph (d). To determine the annual account net gain or loss for such account, the pre-1985 account net gain or loss shall be treated as daily account net gain or loss for purposes of paragraph (c)(2) of this section. See paragraph (c)(5) of this section for treatment of

accrued gain or loss with respect to positions includible in a mixed straddle account.

(e) *Treatment of gains and losses from positions in a mixed straddle account for taxable years ending on or before December 31, 1984*—(1) *In general.* For mixed straddle accounts established on or before December 31, 1984, in taxable years ending on or before December 31, 1984, the taxpayer at the close of the taxable year shall determine gain or loss for each position in the mixed straddle account that has been disposed of on any day during the period beginning on the later of the first day of the taxable year or January 1, 1984, and ending on the last day of the taxable year. Positions in the mixed straddle account that have not been disposed of as of the close of the last business day of the taxable year shall be treated as if sold for their fair market value at the close of such day. Gains and losses from non-section 1256 positions in each mixed straddle account shall be netted to determine *1984 net non-section 1256 position gain or loss* for the account and gains and losses from section 1256 contracts shall be netted to determine *1984 net section 1256 contract gain or loss* for the account. The 1984 net non-section 1256 position gain or loss is then offset against 1984 net section 1256 contract gain or loss from the same mixed straddle account to determine *annual account net gain or loss* for the account. If annual account net gain or loss is attributable to 1984 net non-section 1256 position gain or loss, annual account net gain or loss shall be treated as short-term capital gain or loss. If annual account net gain or loss is attributable to 1984 net section 1256 contract gain or loss, annual account net gain or loss shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. If 1984 net non-section 1256 position gain or loss and 1984 net section 1256 contract gain or loss are either both gains or both losses, that portion of annual account net gain or loss attributable to 1984 net non-section 1256 position gain or loss shall be treated as short-term capital gain or loss and that portion of annual account net gain or loss attributable to 1984 net section 1256 contract gain or loss shall be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. An adjustment (through an adjustment to basis or otherwise) shall be made to any subsequent gain or loss realized with respect to such positions for any gain or loss recognized under this paragraph (e). See paragraph (c) (2) through (5) of this section relating to determining the total annual account net gain or loss, application of section 263(g) to mixed straddle accounts, the limitation on the total annual account net gain or loss, and treatment of accrued gain or loss with respect to positions includible in a mixed straddle account.

(2) *Pre-1984 accrued gain.* If the last business day referred to in paragraph (c)(5) of this section is contained in a period to which such paragraph (c)(5) does not apply, the gains and losses from the deemed sale shall be included in the first period to which paragraph (c)(5) applies.

(f) *Election*—(1) *Time for making the election.* Except as otherwise provided, the election under this section to establish one or more mixed straddle accounts for a taxable year must be made by the due date (without regard to automatic and discretionary extensions) of the taxpayer's income tax return for the immediately preceding taxable year (or part thereof). For example, an individual taxpayer on a calendar year basis must make the election by April 15, 1986, to establish one or more mixed straddle accounts for taxable year 1986. Similarly, a calendar year corporate taxpayer must make its election by March 15, 1986, to establish one or more mixed straddle accounts for 1986. If a taxpayer begins trading or investing in positions in a new class of activities during a taxable year, the election under this section with respect to the new class of activities must be made by the taxpayer by the later of the due date of the taxpayer's income tax return for the immediately preceding taxable year (without regard to automatic and discretionary extensions), or 60 days after the first mixed straddle in the new class of activities is entered into. Similarly, if on or after the date the election is made with respect to an account, the taxpayer begins trading or investing in positions

that are includible in such account but were not specified in the original election, the taxpayer must make an amended election as prescribed in paragraph (f)(2)(ii) of this section by the later of the due date of the taxpayer's income tax return for the immediately preceding taxable year (without regard to automatic and discretionary extensions), or 60 days after the acquisition of the first of the positions. If an election is made after the times specified in this paragraph (f)(1), the election will be permitted only if the Commissioner concludes that the taxpayer had reasonable cause for failing to make a timely election. For example, if a calendar year taxpayer holds few positions in one class of activities prior to April 15 of a taxable year, and the taxpayer greatly increases trading activity with respect to positions in the class of activities after April 15, then the Commissioner may conclude that the taxpayer had reasonable cause for failing to make a timely election and allow the taxpayer to make a mixed straddle account election for the taxable year. See paragraph (f)(2) of this section for rules relating to the manner for making these elections.

(2) *Manner for making the election*—(i) *In general*. A taxpayer must make the election on Form 6781 in the manner prescribed by such Form, and by attaching the Form to the taxpayer's income tax return for the immediately preceding taxable year (or request for an automatic extension). In addition, the taxpayer must attach a statement to Form 6781 designating with specificity the class of activities for which a mixed straddle account is established. The designation must describe the class of activities in sufficient detail so that the Commissioner may determine, on the basis of the designation, whether specific positions are includible in the mixed straddle account. In the case of a taxpayer who elects to establish more than one mixed straddle account, the Commissioner must be able to determine, on the basis of the designations, that specific positions are placed in the appropriate account. The election applies to all positions in the designated class of activities held by the taxpayer during the taxable year.

(ii) *Elections for new classes of activities and expanded elections*. Amended elections and elections made with respect to a new class of activities that the taxpayer has begun trading or investing in during a taxable year, shall be made on Form 6781 within the times prescribed in paragraph (f)(1) of this section. A statement must be attached to the Form containing the information required in paragraph (f)(2)(i) of this section, with respect to the new or expanded designated class of activities.

(iii) *Special rule*. The Commissioner may disregard a mixed straddle account election if the Commissioner determines, on the basis of all the facts and circumstances, that the principal purpose for making the mixed straddle account election with respect to a class of activities was to avoid the rules of § 1.1092(b)–1T (a). For example, if a taxpayer holds stock that is not part of a straddle and that would generate a loss if sold or otherwise disposed of, and the taxpayer both acquires offsetting option positions with respect to the stock and makes a mixed straddle account election with respect to the stock and stock options near the end of a taxable year, the Commissioner may disregard the mixed straddle account election.

(3) *Special rule for taxable years ending after 1983 and before September 1, 1986*. An election under this section to establish one or more mixed straddle accounts for any taxable year that includes July 17, 1984, and any taxable year that ends before September 1, 1986 (or, in the case of a corporation, October 1, 1986), must be made by the later of—

(i) December 31, 1985, or

(ii) The due date (without regard to automatic and discretionary extensions) of the return for the taxpayer's taxable year that begins in 1984 if the due date of the taxpayer's return for such year (without regard to automatic and discretionary extensions) is after December 31, 1985.

The election shall be made by attaching Form 6781 together with a statement to the taxpayer's income tax return, amended return, or other appropriate form that is filed on or before the deadline determined in the preceding sentence. The attached statement must designate with specificity,

in accordance with paragraph (f)(2)(i) of this section, the class of activities for which a mixed straddle account is established. For example, if a fiscal year taxpayer's return (for its taxable year ending September 30, 1985) is due (without regard to extensions) on January 15, 1986, and the taxpayer intends to obtain an automatic extension to file the return, the election under this section for any or all of the fiscal years ending in 1984, 1985 or 1986 must be made on or before January 15, 1986, with the request for an automatic extension. Similarly, a calendar year taxpayer (whether or not such taxpayer has obtained an automatic extension of time to file) who has filed its 1984 income tax return before October 15, 1985, without making a mixed straddle account election for either 1984 or 1985, or both, may make the mixed straddle account election under this section for either or for both of such years with an amended return filed on or before December 31, 1985. The mixed straddle account elected on this amended return will be effective for all positions in the designated class of activities even if the taxpayer had elected straddle-by-straddle identification as provided under §1.1092(b)–3T for purposes of the previously filed 1984 income tax return. For taxable years beginning in 1984 and 1985, the election under this paragraph (f)(3) is effective for the entire taxable year. For taxable years beginning in 1983, an election shall be effective for that part of the year beginning after December 31, 1983, for which the election under §1.1256(h)–1T or 1.1256(h)–2T is made. See §1.6081–1T regarding an extension of time to file certain individual income tax returns.

(4) *Period for which election is effective.* For taxable years beginning on or after January 1, 1984, an election under this section, including an amendment to the election pursuant to paragraph (f)(1) of this section, shall be effective only for the taxable year for which the election is made. This election may be revoked during the taxable year for the remainder of the taxable year only with the consent of the Commissioner. An application for consent to revoke the election shall be filed with the service center with which the election was filed and shall—

(i) Contain the name, address, and taxpayer identification number of the taxpayer;

(ii) Show that the volume or nature of the taxpayer's activities has changed substantially since the election was made, and that the taxpayer's activities no longer warrant the use of such mixed straddle account; and

(iii) Any other relevant information.

If a taxpayer's election for a taxable year is revoked, the taxpayer may not make a new election for the same class of activities under paragraph (f)(1) of this section during the same taxable year.

(g) *Effective date.* The provisions of this section apply to positions held on or after January 1, 1984.

(Secs. 1092(b)(1), 1092(b)(2) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 98 Stat. 627; 26 U.S.C. 1092(b)(1), 1092(b)(2), 7805))

[T.D. 8008, 50 FR 3329, Jan. 24, 1985; 50 FR 12243, Mar. 28, 1985, as amended by T.D. 8058, 50 FR 42013, Oct. 17, 1985]

§ 1.1092(b)–5T Definitions (temporary).

The following definitions apply for purposes of §§1.1092(b)–1T through 1.1092(b)–4T.

(a) *Disposing, disposes, or disposed.* The term *disposing, disposes,* or *disposed* includes the sale, exchange, cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property (as defined in section 1092(d)(1)).

(b) *Hedging transaction.* The term *hedging transaction* means a hedging transaction as defined in section 1256(e).

(c) *Identified straddle.* The term *identified straddle* means an identified straddle as defined in section 1092(a)(2)(B).

(d) *Loss.* The term *loss* means a loss otherwise allowable under section 165(a) (without regard to the limitation contained in section 165(f)) and includes a write-down in inventory.

(e) *Mixed straddle.* The term *mixed straddle* means a straddle—

(1) All of the positions of which are held as capital assets;

(2) At least one (but not all) of the positions of which is a section 1256 contract;

(3) For which an election under section 1256(d) has not been made; and

(4) Which is not part of a larger straddle.

(f) *Non-section 1256 position*. The term *non-section 1256 position* means a position that is not a section 1256 contract.

(g) *Offsetting position*. The term *offsetting position* means an offsetting position as defined in section 1092(c)(2).

(h) *Position*. The term *position* means a position as defined in section 1092(d)(2).

(i) [Reserved]

(j) *Related person or flowthrough entity*. The term *related person or flowthrough entity* means a related person or flowthrough entity as defined in sections 1092(d)(4) (B) and (C) respectively.

(k) *Section 1256 contract*. The term *section 1256 contract* means a section 1256 contract as defined in section 1256(b).

(l) [Reserved]

(m) *Straddle*. The term *straddle* means a straddle as defined in section 1092(c)(1).

(n) *Successor position*. The term *successor position* means a position (''P'') that is or was at any time offsetting to a second position if—

(1) The second position was offsetting to any loss position disposed of; and

(2) P is entered into during a period commencing 30 days prior to, and ending 30 days after, the disposition of the loss position referred to in paragraph (n)(1) of this section.

(o) *Unrecognized gain*. The term *unrecognized gain* means unrecognized gain as defined in section 1092(a)(3)(A).

(p) *Substantially identical*. The term *substantially identical* has the same meaning as substantially identical in section 1091(a).

(q) *Securities*. The term *security* means a security as defined in section 1236(c).

(Secs. 1092(b) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 95 Stat. 324, 26 U.S.C. 1092(b), 7805) and sec. 102(h) of the Tax Reform Act of 1984 (98 Stat. 625))

[T.D. 8007, 50 FR 3321, Jan. 24, 1985, as amended by T.D. 8070, 51 FR 1788, Jan. 15, 1986]

§ 1.1092(b)–6 Mixed straddles; accrued gain and loss associated with a position that becomes part of a section 1092(b)(2) identified mixed straddle that is established after August 18, 2014.

(a) *Treatment of unrealized gain or loss that arose before a position becomes part of an identified mixed straddle*. Except as otherwise provided, if one or more positions of a straddle that is an identified mixed straddle described in section 1092(b)(2)(A)(i)(I) (identified mixed straddle) were held by the taxpayer on the day prior to the day the identified mixed straddle is established, any unrealized gain or loss on the day prior to the day the identified mixed straddle is established with respect to such position or positions is taken into account at the time, and has the character, provided by the provisions of the Internal Revenue Code that would apply to the gain or loss if the identified mixed straddle were not established. Thus, if a non-section 1256 capital asset was held for the long-term capital gain holding period before the identified mixed straddle was established, any unrealized gain or loss on that asset on the day prior to the day the identified mixed straddle was established will be long-term capital gain or loss when that asset is sold or otherwise disposed of in a taxable transaction. Unrealized gain or loss on a section 1256 contract that accrued prior to the day the contract became part of an identified mixed straddle will be recognized no later than the last business day of the taxpayer's taxable year. For each position, unrealized gain or loss is the difference between the fair market value of the position at the close of the day before the day the identified mixed straddle is established and the taxpayer's basis in that position. See § 1.1092(b)–2T and paragraph (b) of this section for the treatment of holding periods with respect to such positions. Changes in value of the position or positions that occur on or after the identified mixed straddle is established are accounted for under the provisions of § 1.1092(b)–3T (other than § 1.1092(b)–3T(b)(6)). The definitions in § 1.1092(b)–5T apply for purposes of this section.

(b) *Holding period after a position becomes part of an identified mixed straddle*.

Section 1.1092(b)–2T(a)(1) applies to any position that becomes part of an identified mixed straddle, and the long-term or short-term character of any gain or loss on that position that arises on or after the day the position has become a position in an identified mixed straddle will be determined by beginning the taxpayer's holding period on the day after the identified mixed straddle ceases to exist.

(c) *Application of the loss deferral rules of section 1092(a).* When applying section 1092(a) and §1.1092(b)–3T(b) (other than §1.1092(b)–3T(b)(6)) to any loss that arises while a position is part of an identified mixed straddle, the amount of unrecognized gain includes both unrecognized gains described in paragraph (a) of this section that accrued prior to the day the identified mixed straddle is established and unrecognized gains that arise on or after the day the identified mixed straddle identification was made for the position.

(d) *Examples.* The rules of this section may be illustrated by the following examples. It is assumed in each example that the positions described are the only positions held directly or indirectly (through a related person or flowthrough entity) by an individual calendar year taxpayer during the taxable year, and no successor positions are acquired or entered into. It is also assumed that gain or loss recognized on any position in the straddle would be capital gain or loss. The following examples assume that the identified mixed straddle is established after the applicability date of this section.

Example 1. (i) *Facts.* On January 13, Year 1, A enters into a section 1256 contract. As of the close of the day on January 15, Year 1, there is $500 of unrealized loss on the section 1256 contract. On January 16, Year 1, A enters into an offsetting non-section 1256 position and makes a valid election to treat the straddle as an identified mixed straddle. A continues to hold both positions of the identified mixed straddle on January 1, Year 2, and there are no further changes to the value of either position in Year 1.

(ii) *Analysis.* On the last business day of Year 1, A recognizes the $500 loss on the section 1256 contract that accrued prior to establishing the identified mixed straddle because the section 1256 contract is treated as sold on December 31, Year 1 (the last business day of the taxable year) under section 1256(a). The loss recognized in Year 1 will be treated as 60% long-term capital loss and 40% short-term capital loss. All gains and losses that arise on or after the identified mixed straddle is established are accounted for under the rules of §§1.1092(b)–2T (and paragraph (b) of this section), 1.1092(b)–3T(b) (other than §1.1092(b)–3T(b)(6)), and paragraph (c) of this section.

Example 2. (i) *Facts.* On December 3, Year 1, A purchases a non-section 1256 position for $100. As of the close of the day on January 22, Year 2, the non-section 1256 position has a fair market value of $500. On January 23, Year 2, A enters into an offsetting section 1256 contract and makes a valid election to treat the straddle as an identified mixed straddle. On February 10, Year 2, A closes out the section 1256 contract at a $500 loss and disposes of the non-section 1256 position for $975.

(ii) *Analysis of pre-straddle gain.* A has $400 of unrealized short-term capital gain attributable to the non-section 1256 position prior to the day the identified mixed straddle was established. This $400 gain is recognized on February 10, Year 2, when the non-section 1256 position is disposed of. Under paragraph (a) of this section, the gain is short-term capital gain because that would have been the character of the gain if the non-section 1256 position had been disposed of on the day prior to establishing the identified mixed straddle.

(iii) *Analysis of straddle gain and loss.* On February 10, Year 2, the gain of $475 ($975 proceeds minus $500 fair market value on the day prior to entering into the identified mixed straddle) on the non-section 1256 position attributable to the identified mixed straddle period is offset by the $500 loss on the section 1256 contract. The net loss of $25 from the identified mixed straddle is recognized and treated as 60% long-term capital loss and 40% short-term capital loss because it is attributable to the section 1256 contract. See §1.1092(b)–3T(b)(4).

Example 3. (i) *Facts.* On January 3, Year 1, A purchases 100 shares of Index Fund for $1,000 ($10 per share). The Index Fund shares are actively traded personal property and are not section 1256 contracts. As of the close of the day on June 24, Year 2, the fair market value of 100 shares of Index Fund is $1,200. On June 25, Year 2, A enters into a short regulated futures contract (Futures Contract) referenced to the same index referenced by Index Fund. Futures Contract is a section 1256 contract and A makes a valid election to treat the shares of Index Fund and Futures Contract as an identified mixed straddle. On December 31, Year 2, the fair market value of A's shares of Index Fund is $1,520 and Futures Contract has lost $300. On January 10, Year 3, A closes out Futures Contract at a loss of $400 when the fair market value of 100 shares of Index Fund is $1,590. On November

20, Year 3, A disposes of all 100 shares of Index Fund for $1,600.

(ii) *Year 2 analysis*. On June 24, Year 2, A has held the Index Fund shares for longer than the long-term holding period, and the $200 of unrecognized gain on the Index Fund shares as of June 24, Year 2, will be characterized as long-term gain under paragraph (a) of this section when the gain is recognized. On December 31, Year 2, Futures Contract is marked to market under section 1256(a)(1). Under paragraph (a) of this section and § 1.1092(b)–3T(b)(4), the loss on Futures Contract of $300 is netted with the $320 unrecognized gain on the Index Fund shares that arose while the identified mixed straddle was in place. Because this unrecognized gain is greater than the deemed realized section 1256 loss, the loss on Futures Contract is treated as a short-term capital loss. The loss, however, will be disallowed in Year 2 under paragraph (c) of this section and the loss deferral rules of section 1092(a) because the unrecognized gain in the Index Fund shares that arose while the identified mixed straddle was in place exceeds the deemed realized loss. Even if this gain were only $250 on December 31, Year 2, the deemed realized loss on Futures Contract would be disallowed because there is $200 of unrecognized gain in the Index Fund shares from the time A held the shares prior to establishing the identified mixed straddle.

(iii) *Year 3 analysis*. When A closes out the Futures Contract on January 10, Year 3, the entire amount of the section 1256 $300 loss that was disallowed on December 31, Year 2, continues to be deferred under paragraph (c) of this section. On November 20, Year 3, A recognizes $200 long-term capital gain from the pre-identified mixed straddle period, and $400 short-term capital gain, $390 of which arose during the identified mixed straddle period and $10 of which arose after the identified mixed straddle was closed. See § 1.1092(b)–2T(a)(1) and paragraph (b) of this section. In Year 3, A recognizes the $300 short-term capital loss from Futures Contract disallowed in Year 2 and the $100 loss accrued on Futures Contract in Year 3 because A no longer holds any positions that were part of an identified mixed straddle.

Example 4. (i) *Facts*. On March 1, Year 1, A purchases a 10-year U.S. Treasury Note (Note) at original issue for $100, which is the stated redemption price at maturity of Note. As of the close of the day on March 1, Year 3, Note has a fair market value of $105. On March 2, Year 3, A enters into a regulated futures contract (Futures Contract) that provides A with a short position in U.S. Treasury Notes and A makes a valid election to treat Note and Futures Contract as an identified mixed straddle. A closes her position in Futures Contract on April 15, Year 3, at a $2 loss. On April 15, Year 3, Note has a fair market value of $108. On December 31, Year 3, Note has a fair market value of $106. A holds Note until it matures on February 28, Year 10.

(ii) *Year 3 analysis*. A has $5 of unrealized gain attributable to Note prior to the day the identified mixed straddle was established. Because A acquired a long-term holding period in Note by March 1, Year 3, the $5 of gain will be characterized as long-term capital gain under paragraph (a) of this section when it is recognized. Under § 1.1092(b)–3T(b)(4), when A closes out Futures Contract on April 15, Year 3, the loss of $2 on Futures Contract is netted with the gain of $3 on Note that arose while the identified mixed straddle was in place. Because this gain on Note exceeds the realized loss on Futures Contract, the loss on Futures Contract is disallowed in Year 3 under paragraph (c) of this section. Further, under paragraph (c) of this section and section 1092(a)(1), on December 31, Year 3, the disallowed loss of $2 on Futures Contract cannot be recognized because it is less than the total unrecognized gain of $6 on Note on December 31, Year 3.

(iii) *Year 10 analysis*. When Note matures in Year 10, the $5 of unrecognized long-term capital gain that arose prior to the identified mixed straddle is recognized. Because A receives $100 upon the maturity of Note, A also recognizes a $5 long-term capital loss on Note, for a net gain of $0 (zero). In addition, the termination of all positions in the identified mixed straddle releases the $2 loss disallowed in Year 3 on Futures Contract. The loss on Futures Contract is treated as short-term capital loss in Year 10 under § 1.1092(b)–3T(b)(4).

(e) *Effective/applicability date*. The rules of this section apply to all section 1092(b)(2) identified mixed straddles established after August 18, 2014.

[T.D. 9678, 79 FR 41888, July 18, 2014]

§ 1.1092(c)–1 Qualified covered calls.

(a) *In general*. Section 1092(c) defines a straddle as offsetting positions with respect to personal property. Under section 1092(d)(3)(B)(i)(I), stock is personal property if the stock is part of a straddle that involves an option on that stock or substantially identical stock or securities. Under section 1092(c)(4), however, writing a qualified covered call option and owning the optioned stock is not treated as a straddle under section 1092 if certain conditions, described in section 1092(c)(4)(B), are satisfied. Section 1092(c)(4)(H) authorizes the Secretary to modify these conditions to carry out

the purposes of section 1092(c)(4) in light of changes in the marketplace.

(b) *Term limitation*—(1) *General rule*. Except as provided in paragraph (b)(2) of this section, an option is not a qualified covered call unless it is granted not more than 12 months before the day on which the option expires or satisfies term limitation and qualified benchmark requirements established by the Commissioner in guidance published in the Internal Revenue Bulletin (*see* § 601.601(d)(2)(ii)(*b*) of this chapter).

(2) *Special benchmark rule for an option granted not more than 33 months before the day on which the option expires*—(i) *In general*. The 12-month limitation described in paragraph (b)(1) of this section is extended to 33 months provided the lowest qualified benchmark is determined using the adjusted applicable stock price, as defined in § 1.1092(c)–4(e).

(ii) *Examples*. The following examples illustrate the rules set out in paragraph (b)(2)(i) of this section:

Example 1. Taxpayer owns stock in Corporation X. Taxpayer writes an equity option with standardized terms on Corporation X stock through a national securities exchange with a term of 21 months. The applicable stock price for Corporation X stock is $100. The bench marks for a 21-month equity option with standardized terms with an applicable stock price of $100 will be based upon the adjusted applicable stock price. Using the table at § 1.1092(c)–4(e), the applicable stock price of $100 is multiplied by the adjustment factor 1.12, resulting in an adjusted applicable stock price of $112. Using the bench marks for an equity option with standardized terms with an adjusted applicable stock price of $112, the highest available strike price less than the adjusted applicable stock price is $110, and the second highest strike price less than the adjusted applicable stock price is $105. Therefore, a 21-month equity call option with standardized terms on Corporation X stock will not be deep in the money if the strike price is not less than $105.

Example 2. Taxpayer owns stock in Corporation Y. Taxpayer writes an equity option with standardized terms on Corporation Y stock through a national securities exchange with a term of 21 months. The applicable stock price for Corporation Y stock is $13.25. The bench marks for a 21-month equity option with standardized terms with an applicable stock price of $13.25 will be based upon the adjusted applicable stock price. Using the table at § 1.1092(c)–4(e), the applicable stock price of $13.25 is multiplied by the adjustment factor 1.12, resulting in an adjusted applicable stock price of $14.84. Using the bench marks for an equity option with standardized terms with an adjusted applicable stock price of $14.84, the highest available strike price less than the adjusted applicable stock price is $12.50. However, under section 1092(c)(4)(D), the lowest qualified bench mark can be no lower than 85% of the applicable stock price, which for Corporation Y stock is $12.61 (85% of the adjusted applicable stock price of $14.84). Thus, because the highest available strike price less than the adjusted applicable stock price for an equity option with standardized terms is lower than the lowest qualified bench mark under section 1092(c)(4)(D), the lowest strike price at which a qualified covered call option can be written is the next higher strike price, or $15.00. Therefore, a 21-month equity call option with standardized terms on Corporation Y stock will not be deep in the money if the strike price is not less than $15.

(c) *Effective date*. This section applies to qualified covered call options entered into on or after July 29, 2002.

[67 FR 20899, Apr. 29, 2002]

§ 1.1092(c)–2 Equity options with flexible terms.

(a) *In general*. Section 1092(c)(4) provides an exception to the general rule that a straddle exists if a taxpayer holds stock and writes a call option on that stock. Under section 1092(c)(4), the ownership of stock and the issuance of a call option meeting certain requirements result in a qualified covered call, which is exempted from the general straddle rules of section 1092. This section addresses the consequences of the availability of equity options with flexible terms under the qualified covered call rules.

(b) *No effect on lowest qualified bench mark for standardized options*. The availability of strike prices for equity options with flexible terms does not affect the determination of the lowest qualified bench mark, as defined in section 1092(c)(4)(D), for an equity option with standardized terms.

(c) *Qualified covered call option status*—(1) *Requirements*. An equity option with flexible terms is a qualified covered call option only if—

(i) The option meets the requirements of section 1092(c)(4)(B) and § 1.1092(c)–1 (taking into account paragraph (c)(2) of this section);

(ii) The only payments permitted with respect to the option are a single fixed premium paid not later than 5 business days after the day on which the option is granted, and a single fixed strike price, as defined in § 1.1092(c)–4(d), that is payable entirely at (or within 5 business days of) exercise;

(iii) An equity option with standardized terms is outstanding for the underlying equity; and

(iv) The underlying security is stock in a single corporation.

(2) *Lowest qualified bench mark*—(i) *In general*. For purposes of determining whether an equity option with flexible terms is deep in the money within the meaning of section 1092(c)(4)(C), the lowest qualified bench mark under section 1092(c)(4)(D) is the same for an equity option with flexible terms as the lowest qualified bench mark for an equity option with standardized terms on the same stock having the same applicable stock price.

(ii) *Examples*. The following examples illustrate the rules set out in paragraph (c)(2)(i) of this section:

Example 1. Taxpayer owns stock in Corporation X. Taxpayer writes an equity call option with flexible terms on Corporation X stock through a national securities exchange for a term of not more than 12 months. The applicable stock price for Corporation X stock is $73.75. Using the bench marks for an equity option with standardized terms with an applicable stock price of $73.75, the highest available strike price less than the applicable stock price is $70, and the second highest strike price less than the applicable stock price is $65. Therefore, an equity call option with flexible terms on Corporation X stock with a term of 90 days or less will not be deep in the money if the strike price is not less than $70. If the term is greater than 90 days, an equity call option with flexible terms on Corporation X will not be deep in the money if the strike price is not less than $65.

Example 2. Taxpayer owns stock in Corporation Y. Taxpayer writes a 9-month equity call option with flexible terms on Corporation Y stock through a national securities exchange. The applicable stock price for Corporation Y stock is $14.75. Using the bench marks for an equity option with standardized terms with an applicable stock price of $14.75, the highest available strike price less than the applicable stock price is $12.50. However, under section 1092(c)(4)(D), the lowest qualified bench mark can be no lower than 85% of the applicable stock price, which for Corporation Y stock is $12.54. Thus, because the highest available strike price less than the applicable stock price for an equity option with standardized terms is lower than the lowest qualified bench mark under section 1092(c)(4)(D), the lowest strike price at which a qualified covered call option can be written is the next higher strike price, or $15.00. This $15.00 strike price requirement for a qualified covered call option applies to equity options with flexible terms, equity options with standardized terms, and qualifying over-the-counter options.

Example 3. Taxpayer owns stock in Corporation Z. On May 8, 2003, Taxpayer writes a 21-month equity call option with flexible terms on Corporation Z stock through a national securities exchange. The applicable stock price for Corporation Z stock is $100. The bench marks for a 21-month equity option with standardized terms with an applicable stock price of $100 will be based upon the adjusted applicable stock price. Using the table at § 1.1092(c)–4(e), the applicable stock price of $100 is multiplied by the adjustment factor 1.12, resulting in an adjusted applicable stock price of $112. The highest available strike price less than the adjusted applicable stock price is $110, and the second highest strike price less than the adjusted applicable stock price is $105. Therefore, a 21-month equity call option with flexible terms on Corporation Z stock will not be deep in the money if the strike price is not less than $105.

(d) *Effective date*—(1) *In general*. Except as provided in paragraph (d)(2) of this section, this section applies to equity options with flexible terms entered into on or after January 25, 2000.

(2) *Effective date for paragraphs (b) and (c) of this section*. Paragraphs (b) and (c) of this section apply to equity options with flexible terms entered into on or after July 29, 2002.

[T.D. 8866, 65 FR 3813, Jan. 25, 2000; Redesignated at 67 FR 20899, Apr. 29, 2002]

§ 1.1092(c)–3 Qualifying over-the-counter options.

(a) *In general*. Under section 1092(c)(4)(B)(i), an equity option is not a qualified covered call option unless it is traded on a national securities exchange that is registered with the Securities and Exchange Commission or other market that the Secretary determines has rules adequate to carry out the purposes of section 1092(c)(4). In accordance with section 1092(c)(4)(H), this requirement is modified as provided in paragraph (b) of this section.

(b) *Qualified covered call option status.* A qualifying over-the-counter option, as defined in §1.1092(c)–4(c), is a qualified covered call option if it meets the requirements of §§1.1092(c)–1 and 1.1092(c)–2(c) after using the language ''qualifying over-the-counter option'' in place of ''equity option with flexible terms''. For purposes of this paragraph (b), a qualifying over-the-counter option is deemed to satisfy the requirements of section 1092(c)(4)(B)(i).

(c) *Effective date.* This section applies to qualifying over-the-counter options entered into on or after July 29, 2002.

[67 FR 20900, Apr. 29, 2002]

§ 1.1092(c)–4 Definitions.

The following definitions apply for purposes of §§1.1092(c)–1 through 1.1092(c)–3:

(a) *Equity option with flexible terms* means an equity option—

(1) That is described in any of the following Securities Exchange Act Releases—

(i) Self-Regulatory Organizations; Order Approving Proposed Rule Changes and Notice of Filing and Order Granting Accelerated Approval of Amendments by the Chicago Board Options Exchange, Inc. and the Pacific Stock Exchange, Inc., Relating to the Listing of Flexible Equity Options on Specified Equity Securities, Securities Exchange Act Release No. 34–36841 (Feb. 21, 1996); or

(ii) Self-Regulatory Organizations; Order Approving Proposed Rule Changes and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 2 and 3 to the Proposed Rule Change by the American Stock Exchange, Inc., Relating to the Listing of Flexible Equity Options on Specified Equity Securities, Securities Exchange Act Release No. 34–37336 (June 27, 1996); or

(iii) Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 2, 4 and 5 to the Proposed Rule Change by the Philadelphia Stock Exchange, Inc., Relating to the Listing of Flexible Exchange Traded Equity and Index Options, Securities Exchange Act Release No. 34–39549 (Jan. 23, 1998); or

(iv) Any changes to the Security Exchange Act Releases described in paragraphs (a)(1)(i) through (iii) of this section that are approved by the Securities and Exchange Commission; or

(2) That is traded on any national securities exchange that is registered with the Securities and Exchange Commission (other than those described in the Security Exchange Act Releases set forth in paragraph (a)(1) of this section) and is—

(i) Substantially identical to the equity options described in paragraph (a)(1) of this section; and

(b) *Equity option with standardized terms* means an equity option—

(1) That is traded on a national securities exchange registered with the Securities and Exchange Commission;

(2) That, on the date the option is written, expires on the Saturday following the third Friday of the month of expiration;

(3) That has a strike price that is set at a uniform minimum strike price interval, that is established by the applicable national securities exchange registered with the Securities and Exchange Commission, and that is not less than $1.00; and

(4) That has stock in a single corporation as its underlying security.

(c) *Qualifying over-the-counter option* means an equity option that—

(1) Is not traded on a national securities exchange registered with the Securities and Exchange Commission; and

(2) Is entered into with—

(i) A broker-dealer, acting as principal or agent, who is registered with the Securities and Exchange Commission under section 15 of the Securities Act of 1934 (15 U.S.C. 78a through 78mm) and the regulations thereunder and who must comply with the recordkeeping requirements of 17 CFR 240.17a–3; or

(ii) An alternative trading system under 17 CFR 242.300 through 17 CFR 242.303; or

(iii) A person, acting as principal or agent, who must comply with the recordkeeping requirements for securities transactions described in 12 CFR 12.3, 12 CFR 208.34, or 12 CFR 344.4.

(d) *Single fixed strike price* means a strike price that is fixed, determinable, and stated as a dollar amount on the

date the option is written. An option will not fail to have a single fixed strike price if, after the date the option is written, the strike price is adjusted to account for the effects of a dividend, stock dividend, stock distribution, stock split, reverse stock split, rights offering, distribution, reorganization, recapitalization, or reclassification with respect to the underlying security, or a merger, consolidation, dissolution, or liquidation of the issuer of the underlying security.

(e) *Adjusted applicable stock price* means the applicable stock price, as defined in section 1092(c)(4)(G), adjusted for time. To determine the adjusted applicable stock price, the applicable stock price, which is determined in accordance with the rules in section 1092(c)(4)(G), is multiplied by an adjustment factor. The adjustment factor table is as follows:

Option term (in months)		Adjustment factor
Greater than	Not more than	
12	15	1.08
15	18	1.10
18	21	1.12
21	24	1.14
24	27	1.16
27	30	1.18
30	33	1.20

(f) *Securities Exchange Act Release* means a release issued by the Securities and Exchange Commission. To determine identifying information for releases referenced in paragraph (d)(1) of this section, including release titles, identification numbers, and issue dates, contact the Office of the Secretary, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549. To obtain a copy of a Securities Exchange Act Release, submit a written request, including the specific release identification number, title, and issue date, to Securities and Exchange Commission, Attention Public Reference, 450 5th Street, NW., Washington, DC 20549.

(g) *Effective dates.* (1) Except for paragraph (a)(2) of this section, paragraph (a) of this section applies to equity options with flexible terms entered into on or after January 25, 2000. Paragraph (a)(2) of this section applies to equity options with flexible terms entered into on or after July 29, 2002.

(2) Paragraphs (b), (c), (d), and (e) of this section apply to equity options entered into on or after July 29, 2002.

(3) Paragraph (f) of this section applies to equity options entered into on or after January 25, 2000.

[67 FR 20900, 20901, Apr. 29, 2002]

§ 1.1092(d)–1 Definitions and special rules.

(a) *Actively traded.* Actively traded personal property includes any personal property for which there is an established financial market.

(b) *Established financial market*—(1) *In general.* For purposes of this section, an established financial market includes—

(i) A national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);

(ii) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934;

(iii) A domestic board of trade designated as a contract market by the Commodities Futures Trading Commission;

(iv) A foreign securities exchange or board of trade that satisfies analogous regulatory requirements under the law of the jurisdiction in which it is organized (such as the London International Financial Futures Exchange, the Marche a Terme International de France, the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited, the Frankfurt Stock Exchange, and the Tokyo Stock Exchange);

(v) An interbank market;

(vi) An interdealer market (as defined in paragraph (b)(2)(i) of this section); and

(vii) Solely with respect to a debt instrument, a debt market (as defined in paragraph (b)(2)(ii) of this section).

(2) *Definitions*—(i) *Interdealer market.* An interdealer market is characterized by a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations (including rates, yields, or other pricing information) of one or more identified brokers, dealers, or

traders or actual prices (including rates, yields, or other pricing information) of recent transactions. An interdealer market does not include a directory or listing of brokers, dealers, or traders for specific contracts (such as yellow sheets) that provides neither price quotations nor actual prices of recent transactions.

(ii) *Debt market*. A debt market exists with respect to a debt instrument if price quotations for the instrument are readily available from brokers, dealers, or traders. A debt market does not exist with respect to a debt instrument if—

(A) No other outstanding debt instrument of the issuer (or of any person who guarantees the debt instrument) is traded on an established financial market described in paragraph (b)(1)(i), (ii), (iii), (iv), (v), or (vi) of this section (other traded debt);

(B) The original stated principal amount of the issue that includes the debt instrument does not exceed $25 million;

(C) The conditions and covenants relating to the issuer's performance with respect to the debt instrument are materially less restrictive than the conditions and covenants included in all of the issuer's other traded debt (e.g., the debt instrument is subject to an economically significant subordination provision whereas the issuer's other traded debt is senior); or

(D) The maturity date of the debt instrument is more than 3 years after the latest maturity date of the issuer's other traded debt.

(c) *Notional principal contracts*. For purposes of section 1092(d)—

(1) A notional principal contract (as defined in §1.446–3(c)(1)) constitutes personal property of a type that is actively traded if contracts based on the same or substantially similar specified indices are purchased, sold, or entered into on an established financial market within the meaning of paragraph (b) of this section; and

(2) The rights and obligations of a party to a notional principal contract are rights and obligations with respect to personal property and constitute an interest in personal property.

(d) *Debt instrument linked to the value of personal property*. If a taxpayer is the obligor under a debt instrument one or more payments on which are linked to the value of personal property or a position with respect to personal property, then the taxpayer's obligation under the debt instrument is a position with respect to personal property and may be part of a straddle.

(e) *Effective/applicability dates*—(1) Paragraphs (a) and (b) of this section apply to positions entered into on or after October 14, 1993.

(2) Paragraph (c) of this section applies to positions entered into on or after July 8, 1991.

(3) Paragraph (d) of this section applies to straddles established on or after January 17, 2001.

[T.D. 8491, 58 FR 53135, Oct. 14, 1993, as amended by T.D. 9635, 78 FR 54569, Sept. 5, 2013; T.D. 9691, 79 FR 51091, Aug. 27, 2014]

§ 1.1092(d)–2 Personal property.

(a) *Special rules for stock*. Under section 1092(d)(3)(B), personal property includes any stock that is part of a straddle, at least one of the offsetting positions of which is a position with respect to substantially similar or related property (other than stock). For purposes of this rule, the term *substantially similar or related property* is defined in §1.246–5 (other than §1.246–5(b)(3)). The rule in §1.246–5(c)(6) does not narrow the related party rule in section 1092(d)(4).

(b) *Effective date*—(1) *In general*. This section applies to positions established on or after March 17, 1995.

(2) *Special rule for certain straddles*. This section applies to positions established after March 1, 1984, if the taxpayer substantially diminished its risk of loss by holding substantially similar or related property involving the following types of transactions—

(i) Holding offsetting positions consisting of stock and a convertible debenture of the same corporation where the price movements of the two positions are related; or

(ii) Holding a short position in a stock index regulated futures contract (or alternatively an option on such a regulated futures contract or an option on the stock index) and stock in an investment company whose principal holdings mimic the performance of the stocks included in the stock index (or

alternatively a portfolio of stocks whose performance mimics the performance of the stocks included in the stock index).

[T.D. 8590, 60 FR 14641, Mar. 20, 1995]

CAPITAL GAINS AND LOSSES

Treatment of Capital Gains

§ 1.1201–1 Alternative tax.

(a) *Corporations*—(1) *In general.* (i) If for any taxable year a corporation has net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977) (as defined in section 1222(11)) section 1201(a) imposes an alternative tax in lieu of the tax imposed by sections 11 and 511, but only if such alternative tax is less than the tax imposed by sections 11 and 511. The alternative tax is not in lieu of the personal holding company tax imposed by section 541 or of any other tax not specifically set forth in section 1201(a).

(ii) In the case of an insurance company, the alternative tax imposed by section 1201(a) is also in lieu of the tax imposed by sections 821 (a) or (c) and 831 (a), except that for taxable years beginning before January 1, 1963, the reference to section 821 (a) or (c) is to be read as reference to section 821 (a)(1) or (b). For taxable years beginning after December 31, 1954, and before January 1, 1958, the alternative tax imposed by section 1201(a) shall also be in lieu of the tax imposed by section 802(a), as amended by the Life Insurance Company Tax Act for 1955 (70 Stat. 38), if such alternative tax is less than the tax imposed by such section. See section 802(e), as added by the Life Insurance Company Tax Act for 1955 (70 Stat. 39). However, for taxable years beginning after December 31, 1958, and before January 1, 1962, section 802(a)(2), as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 115), imposes a separate tax equal to 25 percent of the amount by which the net long-term capital gain of any life insurance company (as defined in section 801(a) and paragraph (b) of § 1.801–3) exceeds its net short-term capital loss. See paragraph (f) of § 1.802–3. For alternative tax for life insurance companies in the case of taxable years beginning after December 31, 1961, see section 802(a)(2) and the regulations thereunder.

(iii) See section 56 and the regulations thereunder for provisions relating to the minimum tax for tax preferences.

(2) *Alternative tax.* The alternative tax is the sum of:

(i) A partial tax computed at the rates provided in sections 11, 511, 821 (a) or (c), and 831(a), on the taxable income of the taxpayer reduced by the amount of the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977), and

(ii) An amount equal to the tax determined under subparagraph (3) of this paragraph.

For taxable years beginning after December 31, 1954, and before January 1, 1958, the partial tax under subdivision (i) of this subparagraph shall also be computed at the rates provided in section 802(a). For taxable years beginning before January 1, 1963, the reference in such subdivision to section 821 (a) or (c) is to be read as a reference to section 821 (a) or (b).

(3) *Tax on capital gains.* For purposes of subparagraph (2)(ii) of this paragraph, the tax shall be:

(i) In the case of a taxable year beginning after December 31, 1974, a tax of 30 percent of the net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976),

(ii) In the case of a taxable year beginning after December 31, 1969, and before January 1, 1975:

(*a*) A tax of 25 percent of the lesser of the amount of the subsection (d) gain (as defined in section 1201(d) and paragraph (f) of this section) or the amount of the net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976), plus

(*b*) A tax of 30 percent (28 percent in the case of a taxable year beginning after December 31, 1969, and before January 1, 1971) of the excess, if any, of the net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976) over the subsection (d) gain,

(iii) In the case of a taxable year beginning before January 1, 1970, and after March 31, 1954, a tax of 25 percent of the net section 1201 gain (net capital

gain for taxable years beginning after December 31, 1976), or

(iv) In the case of a taxable year beginning before April 1, 1954, a tax of 26 percent of the net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976).

(4) *Determination of special deductions.* In the computation of the partial tax described in subparagraph (2)(i) of this paragraph the special deductions provided for in sections 243, 244, 245, 247, 922, and 941 shall not be recomputed as the result of the reduction of taxable income by the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977).

(b) *Other taxpayers*—(1) *In general.* If for any taxable year a taxpayer (other than a corporation) has net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977) (as defined in section 1222(11)) section 1201(b) imposes an alternative tax in lieu of the tax imposed by sections 1 and 511, but only if such alternative tax is less than the tax imposed by sections 1 and 511. The alternative tax is not in lieu of any other tax not specifically set forth in section 1201(b). See section 56 and the regulations thereunder for provisions relating to the minimum tax for tax preferences.

(2) *Alternative tax.* The alternative tax is the sum of:

(i) A partial tax computed at the rates provided by sections 1 and 511 on the taxable income reduced by an amount equal to 50 percent of the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977), and

(ii) In the case of a taxable year beginning after December 31, 1969:

(*a*) A tax of 25 percent of the lesser of the amount of the subsection (d) gain (as defined in section 1201(d) and paragraph (f) of this section) or the amount of the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977), plus

(*b*) A tax computed as provided in section 1201(c) and paragraph (e) of this section on the excess, if any, of the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977) over the subsection (d) gain, or

(iii) In the case of a taxable year beginning before January 1, 1970, a tax of 25 percent of the net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976).

(3) *Cross references.* See §1.1–2(a) for rule relating to the computation of the limitation on tax in cases where the alternative tax is imposed. See §1.34–2 (a) for rule relating to the computation of the dividend received credit under section 34 (for dividends received on or before December 31, 1964), and §1.35–1 (a) for rule relating to the computation of credit for partially tax-exempt interest under section 35 in cases where the alternative tax is imposed.

(c) *Tax-exempt trusts and organizations.* In applying section 1201 in the case of tax-exempt trusts or organizations subject to the tax imposed by section 511, the only amount which is taken into account as capital gain or loss is that which is taken into account in computing unrelated business taxable income under section 512. Under section 512, the only amount taken into account as capital gain or loss is that resulting from the application of section 631(a), relating to the election to treat the cutting of timber as a sale or exchange.

(d) *Joint returns.* In the case of a joint return, the excess of any net long-term capital gain over any net short-term capital loss is to be determined by combining the long-term capital gains and losses and the short-term capital gains and losses of the spouses.

(e) *Computation of tax on capital gain in excess of subsection (d) gain*—(1) *In general.* The tax computed for purposes of section 1201(b)(3) and paragraph (b)(2)(ii)(*b*) of this section shall be the amount by which a tax determined under section 1 or 511 on an amount equal to the taxable income (but not less than 50 percent of the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977)) for the taxable year exceeds a tax determined under section 1 or 511 on an amount equal to the sum of (i) the amount subject to tax under section 1201 (b)(1) and paragraph (b)(2)(i) of this section for such year plus (ii) an amount equal to 50 percent of the subsection (d) gain for such year.

(2) *Limitation.* Notwithstanding subparagraph (1) of this paragraph, the tax computed for purposes of section

1201(b) (3) and paragraph (b)(2)(ii)(*b*) of this section shall not exceed an amount equal to the following percentage of the excess of the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977) over the subsection (d) gain for the taxable year:

(i) 29½ percent, in the case of a taxable year beginning after December 31, 1969, and before January 1, 1971, or

(ii) 32½ percent, in the case of a taxable year beginning after December 31, 1970, and before January 1, 1972.

(f) *Definition of subsection (d) gain*—(1) *In general*. For purposes of section 1201 and this section, the term *subsection (d) gain* means the sum of the long-term capital gains for the taxable year arising:

(i) In the case of amounts received or accrued, as the case may be, before January 1, 1975 (other than any gain from a transaction described in section 631 or 1235), from:

(*a*) Sales or other dispositions on or before October 9, 1969, including sales or other dispositions the income from which is returned as provided in section 453 (a)(1) or (b)(1), or

(*b*) Sales or other dispostions after October 9, 1969, pursuant to binding contracts entered into on or before that date, including sales or other dispositions the income from which is returned as provided in section 453 (a)(1) or (b)(1),

(ii) From liquidating distributions made by a corporation which are made (a) before October 10, 1970, and (b) pursuant to a plan of complete liquidation adopted on or before October 9, 1969, or

(iii) In the case of a taxpayer (other than a corporation), from any other source not described in subdivision (i) or (ii) of this subparagraph, but the amount taken into account from such other sources shall be limited to the amount, if any, by which $50,000 ($25,000 in the case of a married individual filing a separate return) exceeds the sum of the gains to which subdivisions (i) and (ii) of this subparagraph apply.

(2) *Special rules*. For purposes of subparagraph (1) of this paragraph:

(i) A binding contract entered into on or before October 9, 1969, means a contract, whether written or unwritten, which on or before that date was legally enforceable against the taxpayer under applicable law. If on or before October 9, 1969, a taxpayer grants an irrevocable option or irrevocable contractual right to another party to buy certain property and such other party exercises that option or right after October 9, 1969, the sale of such property is a sale pursuant to a binding contract entered into on or before October 9, 1969. The application of this subdivision may be illustrated by the following example:

Example: During 1964, A, B, and C formed a closely held corporation, and A was appointed as president of the organization. On July 1, 1964, A received for consideration 100 shares of common stock in the corporation subject to the agreement that, if A should retire from the management of the corporation or die, A or his estate would first offer his shares of stock to the corporation for purchase and that, if the corporation did not buy the stock within 60 days, the stock could be sold to any party other than the corporation. On September 1, 1970, A retired from the management of the corporation and offered his shares to the corporation for purchase. Pursuant to the agreement, the corporation purchased A's stock on September 30, 1970. A's sale of such stock was pursuant to a binding contract entered into on or before October 9, 1969.

(ii) A contract which pursuant to subdivision (i) of this subparagraph constitutes a binding contract entered into on or before October 9, 1969, does not cease to qualify as such a contract by reason of the fact that after October 9, 1969, there is a modification of the terms of the contract such as a change in the time of performance, or in the amount of the debt or in the terms and mode of payment, or in the rate of interest, or there is a change in the form or nature of the obligation or the character of the security, so long as the taxpayer is at all times on and after October 9, 1969, legally bound by such contract. The application of this subdivision may be illustrated by the following examples:

Example 1. On August 1, 1969, A sold certain capital assets to B on the installment plan and elected to return the gain therefrom under section 453, the agreement providing for payments over a period of 2 years. At the time of the sale these assets had been held by A for more than 6 months. On July 31, 1970, A and B agreed to a modification of the terms of payment under the sales agreement,

the only change in the contract being that the installment payments due after July 31, 1970, would be paid over a 3-year period. For purposes of this paragraph the payments received by A after July 31, 1970, are considered amounts received from the sale on August 1, 1969. (See section 483 for rules with respect to interest on deferred payments.)

Example 2. On April 1, 1969, A sold certain capital assets to B on the installment plan and elected to return the gain therefrom under section 453, the agreement providing for payments over a period of 3 years. At the time of the sale these assets had been held by A for more than 6 months. On March 31, 1970, C assumed B's obligation to pay the balance of the installments which were due after that date. For purposes of this paragraph any installment payments received by A after March 31, 1970, from C are considered amounts received from a sale made on or before October 9, 1969.

Example 3. On May 1, 1969, A offers to sell certain capital assets to B if B accepts the offer within 1 year, unless it is previously withdrawn by A. B accepts the offer on November 1, 1969, and the transaction is consummated shortly thereafter. For purposes of this paragraph, any payment received by A pursuant to the sale is not considered an amount received from a sale made on or before October 9, 1969, or from a sale pursuant to a binding contract entered into on or before that date.

(iii) An amount which is considered under section 402(a)(2) or 403(a)(2) as gain of the taxpayer from the sale or exchange of a capital asset held for more than 6 months shall be treated as gain subject to the provisions of section 1201 (d)(1) and subdivision (i) of such subparagraph, but only if on or before October 9, 1969, (*a*) the employee with respect to whom such amount is distributed or paid, died or was otherwise separated from the service, and (*b*) the terms of the plan required, or the employee elected, that total distributions or amounts payable be paid to the taxpayer within 1 taxable year.

(iv) Gain described in section 1201(d)(1) or (2) with respect to a partnership, estate, or trust, which is required to be included in the gross income of a partner in such partnership, or of a beneficiary of such estate or trust, shall be treated as such gain with respect to such partner or beneficiary. Thus, for example, if during 1974 a partnership which uses the calendar year as its taxable year receives amounts which give rise to section 1201(d)(1) gain, a partner who uses the fiscal year ending June 30 as his taxable year shall treat his distributive share of such gain as subsection (d) gain for his taxable year ending June 30, 1975, even though such share is distributed to him after December 31, 1974. See § 1.706–1.

(v) An individual shall be considered married for purposes of subdivision (iii) of such subparagraph if for the taxable year he may elect with his spouse to make a joint return under section 6013(a).

(vi) In applying such subparagraph for purposes of section 21(a) (1) long-term capital gains arising from amounts received before January 1, 1970, shall be taken into account if such amounts are received during the taxable year.

(g) *Illustrations.* The application of this section may be illustrated by the following examples in which the assumption is made that section 56 (relating to minimum tax for tax preferences) does not apply:

Example 1. A, a single individual, has for the calendar year 1954 taxable income (exclusive of capital gains and losses) of $99,400. He realizes in 1954 a gain of $50,000 on the sale of a capital asset held for 19 months and sustains a loss of $20,000 on the sale of a capital asset held for 5 months. He had no other capital gains or losses. Since the alternative tax is less than the tax otherwise computed under section 1, the tax payable is the alternative tax, that is $74,298. The tax is computed as follows:

Tax Under Section 1		
Taxable income exclusive of capital gains and losses		$99,400
Net long-term capital gain (100 percent of $50,000)	$50,000	
Net short-term capital loss (100 percent of $20,000)	20,000	
Excess of net long-term capital gain over the net short-term capital loss		30,000
		129,400
Deduction of 50 percent of excess of net long-term capital gain over the net short-term capital loss (section 1202)		15,000
Taxable income		114,400
Tax under section 1		80,136
Alternative Tax Under Section 1201(b)		
Taxable income		$114,400
Less 50 percent of excess of net long-term capital gain over net short-term capital loss (section 1201(b)(1))		15,000
Taxable income exclusive of capital gains and losses		99,400
Partial tax (tax on $99,400)		66,798

Plus 25 percent of $30,000	7,500
Alternative tax under section 1201(b)	74,298

Example 2. A husband and wife, who file a joint return for the calendar year 1970, have taxable income (exclusive of capital gains and losses) of $100,000. In 1970 they realize $200,000 of net long-term capital gain in excess of net short-term capital loss, including long-term capital gains of $100,000 arising from sales consummated in 1968 the income from which is returned on the installment method under section 453, and long-term capital gains of $50,000, arising in respect of distributions from X corporation made before October 10, 1970, which were pursuant to a plan of complete liquidation adopted on October 9, 1969. Since the alternative tax under section 1201(b) is less than the tax otherwise computed under section 1, the tax payable for 1970 is the alternative tax, that is, $97,430 plus the tax surcharge under section 51. The tax (without regard to the tax surcharge) is computed as follows:

Tax Under Section 1		
Taxable income exclusive of capital gains and losses		$100,000
Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976) (excess of net long-term capital gain over the net short-term capital loss)		200,000
Total		300,000
Deduction of 50 percent of net section 1201 (net capital gain for taxable years beginning after December 31, 1976) gain (section 1202)		100,000
Taxable income		200,000
Tax under section 1		110,980
Alternative Tax Under Section 1201(b)		
(1) Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)		$200,000
(2) Subsection (d) gain:		
Section 1201(d)(1)		100,000
Section 1201(d)(2)		50,000
Total subsection (d) gain		150,000
(3) Net section 1201 (net capital gain for taxable years beginning after December 31, 1976) gain in excess of subsection (d) gain ($200,000 less $150,000)		50,000
(4) Tax under section 1201(b)(1):		
(i) Taxable income	$200,000	
(ii) Less: 50% of item (1)	100,000	
(iii) Amount subject to tax under section 1201(b)(1)	100,000	
Partial tax (computed under section 1)		45,180
(5) Tax under section 1201(b)(2): (25% of item (1) or of item (2), whichever is lesser [25% of $150,000])		37,500
(6) Tax under section 1201(b)(3) on item (3):		
Tax under section 1 on taxable income ($200,000)	$110,980	
Less: Tax under section 1 on sum of item (4)(iii)(c) ($100,000) plus 50% of item (2) ($75,000) (Total $175,000)	93,780	
Tax under section 1201(c)(1)	17,200	
Limitation under section. 1201(c)(2)(A) (29½% of item (3))	14,750	14,750
(7) Alternative tax under section 1201(b)		97,430

Example 3. A husband and wife, who file a joint return for the calendar year 1971, have taxable income (exclusive of capital gains and losses) of $80,000. In 1971 they realize long-term capital gain of $30,000 arising from a sale consummated on July 1, 1969, the income from which is returned on the installment method under section 453. From securities transactions in 1971 they have long-term capital gains of 60,000 and a short-term capital loss of $10,000. Since the alternative tax under section 1201(b) is less than the tax otherwise computed under section 1, the tax payable is the alternative tax, that is, $55,140. The tax is computed as follows:

Tax Under Section 1		
Taxable income exclusive of capital gains and losses		$80,000
Net long-term capital gains (100% of $90,000)	$90,000	
Net short-term capital loss (100% of $10,000)	10,000	
Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)		80,000
Total		160,000
Deduction of 50% of net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976) (section 1202)		40,000
Taxable income		120,000
Tax under section 1		57,580
Alternative Tax Under Section 1201(b)		
(1) Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)		$80,000
(2) Subsection (d) gain:		
Section 1201(d)(1)		30,000
Section 1201(d)(2).		
Section 1201(d)(3) ($50,000 less $30,000)		20,000
Total subsection (d) gain		50,000
(3) Net section 1201 (net capital gain for taxable years beginning after December 31, 1976) gain in excess of subsection (d) gain ($80,000 less $50,000)		30,000
(4) Tax under section 1201(b)(1):		
(i) Taxable income	$120,000	
(ii) Less: 50% of item (1)	40,000	
(iii) Amount subject to tax under section 1201(b)(1)	80,000	
Partial tax (computed under section 1)		33,340
(5) Tax under section 1201(b)(2): (25% of item (1) or of item (2), whichever is lesser [25% of $50,000])		12,500

(6) Tax under section 1201 (b)(3) on item (3):		
Tax under section 1 on taxable income ($120,000)	$57,580	
Less: Tax under sec. 1 on sum of item (4) (iii) ($80,000) plus 50% of item (2) ($25,000) (Total $105,000)	$48,280	
Tax under section 1201(c)(1)	9,300	
Limitation under section 1201(c) (2)(B) (32½% of item (3))	9,750	$9,300
(7) Alternative tax under section 1201(b)		55,140

Example 4. A husband and wife, who file a joint return for the calendar year 1973, have taxable income (exclusive of capital gains and losses) of $250,000. In 1973 they realize long-term capital gains (not described in section 1201(d) (1) or (2)) of $140,000 and a short-term capital loss of $50,000. Since the alternative tax under section 1201(b) is less than the tax otherwise computed under section 1, the tax payable is the alternative tax, that is, $172,480. The tax is computed as follows:

Tax Under Section 1		
Taxable income exclusive of capital gains and losses		$250,000
Net long-term capital gains (100% of $140,000)	$140,000	
Net short-term capital loss (100% of $50,000)	50,000	
Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)		90,000
Total		340,000
Deduction of 50% of net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976) (section 1202)		45,000
Taxable income		295,000
Tax under section 1		177,480
Alternative Tax Under Section 1201(b)		
(1) Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976)		$90,000
(2) Subsection (d) gain:		
Section 1201(d)(1)		.....
Section 1201(d)(2)		.....
Section 1201(d)(3)		50,000
Total subsection (d) gain		50,000
(3) Net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976) in excess of subsection (d) gain ($90,000 less $50,000)		40,000
(4) Tax under section 1201(b)(1):		
(i) Taxable income	$295,000	
(ii) Less: 50% of item (1)	45,000	
(iii) Amount subject to tax under section 1201(b)(1)	250,000	
Partial tax (computed under section 1)		145,980
(5) Tax under section 1201(b)(2): (25% of item (1) or of item (2), whichever is lesser [25% of $50,000])		$12,500
(6) Tax under section 1201(b)(3) on item (3):		
Tax under section 1 on taxable income ($295,000)	$177,480	
Less: Tax under section 1 on sum of item (4) (iii) ($250,000) plus 50% of item (2) ($25,000) (Total $275,000)	163,480	14,000
(7) Alternative tax under section 1201(b)		172,480

[T.D. 7337, 39 FR 44975, Dec. 30, 1974, as amended by T.D. 7728, 45 FR 72651, Nov. 3, 1980]

§ 1.1202–0 Table of contents.

This section lists the major captions that appear in the regulations under § 1.1202–2.

§ 1.1202–2 Qualified small business stock; effect of redemptions.

(a) Redemptions from taxpayer or related person.
(1) In general.
(2) De minimis amount.
(b) Significant redemptions.
(1) In general.
(2) De minimis amount.
(c) Transfers by shareholders in connection with the performance of services not treated as purchases.
(d) Exceptions for termination of services, death, disability or mental incompetency, or divorce.
(1) Termination of services.
(2) Death.
(3) Disability or mental incompetency.
(4) Divorce.
(e) Effective date.

[T.D. 8749, 62 FR 68166, Dec. 31, 1997]

§ 1.1202–1 Deduction for capital gains.

(a) In computing gross income, adjusted gross income, taxable income, capital gain net income (net capital gain for taxable years beginning before January 1, 1977) and net capital loss, 100 percent of any gain or loss (computed under section 1001, recognized under section 1002, and taken into account without regard to subchapter P (section 1201 and following), chapter 1 of the Code) upon the sale or exchange of a capital asset shall be taken into account regardless of the period for which the capital asset has been held. Nevertheless, the net short-term capital gain or loss and the net long-term capital gain or loss must be separately computed. In computing the adjusted gross income or the taxable income of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term

capital loss, 50 percent of the amount of the excess is allowable as a deduction from gross income under section 1202.

(b) For the purpose of computing the deduction allowable under section 1202 in the case of an estate or trust, any long-term or short-term capital gains which, under sections 652 and 662, are includible in the gross income of its income beneficiaries as gains derived from the sale or exchange of capital assets must be excluded in determining whether, for the taxable year of the estate or trust, its net long-term capital gain exceeds its net short-term capital loss. To determine the extent to which such gains are includible in the gross income of a beneficiary, see the regulations under sections 652 and 662. For example, during 1954 a trust realized a gain of $1,000 upon the sale of stock held for 10 months. Under the terms of the trust instrument all of such gain must be distributed during the taxable year to A, the sole income beneficiary. Assuming that under section 652 or 662 A must include all of such gain in his gross income, the trust is not entitled to any deduction with respect to such gain under section 1202. Assuming A had no other capital gains or losses for 1954, he would be entitled to a deduction of $500 under section 1202. For purposes of this section, an income beneficiary shall be any beneficiary to whom an amount is required to be distributed, or is paid or credited, which is includible in his gross income.

(c) The provisions of this section may be illustrated by the following example:

Example: A, an individual, had the following transactions in 1954:

Long-term capital gain	$6,000	
Long-term capital loss	4,000	
Net long-term capital gain		$2,000
Short-term capital loss	1,800	
Short-term capital gain	300	
Net short-term capital loss		1,500
Excess of net long-term capital gain over net short-term capital loss		500

Since the net long-term capital gain exceeds the net short-term capital loss by $500, 50 percent of the excess, or $250, is allowable as a deduction under section 1202.

[T.D. 6500, 25 FR 12001, Nov. 26, 1960, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1202–2 Qualified small business stock; effect of redemptions.

(a) *Redemptions from taxpayer or related person*—(1) *In general.* Stock acquired by a taxpayer is not qualified small business stock if, in one or more purchases during the 4-year period beginning on the date 2 years before the issuance of the stock, the issuing corporation purchases (directly or indirectly) more than a de minimis amount of its stock from the taxpayer or from a person related (within the meaning of section 267(b) or 707(b)) to the taxpayer.

(2) *De minimis amount.* For purposes of this paragraph (a), stock acquired from the taxpayer or a related person exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of the stock held by the taxpayer and related persons is acquired. The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

(b) *Significant redemptions*—(1) *In general.* Stock is not qualified small business stock if, in one or more purchases during the 2-year period beginning on the date 1 year before the issuance of the stock, the issuing corporation purchases more than a de minimis amount of its stock and the purchased stock has an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of the issuing corporation's stock as of the beginning of such 2-year period.

(2) *De minimis amount.* For purposes of this paragraph (b), stock exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds

$10,000 and more than 2 percent of all outstanding stock is purchased. The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of the stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

(c) *Transfers by shareholders in connection with the performance of services not treated as purchases.* A transfer of stock by a shareholder to an employee or independent contractor (or to a beneficiary of an employee or independent contractor) is not treated as a purchase of the stock by the issuing corporation for purposes of this section even if the stock is treated as having first been transferred to the corporation under § 1.83–6(d)(1) (relating to transfers by shareholders to employees or independent contractors).

(d) *Exceptions for termination of services, death, disability or mental incompetency, or divorce.* A stock purchase is disregarded if the stock is acquired in the following circumstances:

(1) *Termination of services*—(i) *Employees and directors.* The stock was acquired by the seller in connection with the performance of services as an employee or director and the stock is purchased from the seller incident to the seller's retirement or other bona fide termination of such services;

(ii) *Independent contractors.* [Reserved]

(2) *Death.* Prior to a decedent's death, the stock (or an option to acquire the stock) was held by the decedent or the decedent's spouse (or by both), by the decedent and joint tenant, or by a trust revocable by the decedent or the decedent's spouse (or by both), and—

(i) The stock is purchased from the decedent's estate, beneficiary (whether by bequest or lifetime gift), heir, surviving joint tenant, or surviving spouse, or from a trust established by the decedent or decedent's spouse; and

(ii) The stock is purchased within 3 years and 9 months from the date of the decedent's death;

(3) *Disability or mental incompetency.* The stock is purchased incident to the disability or mental incompetency of the selling shareholder; or

(4) *Divorce.* The stock is purchased incident to the divorce (within the meaning of section 1041(c)) of the selling shareholder.

(e) *Effective date.* This section applies to stock issued after August 10, 1993.

[T.D. 8749, 62 FR 68166, Dec. 31, 1997]

TREATMENT OF CAPITAL LOSSES

§ 1.1211–1 Limitation on capital losses.

(a) *Corporations*—(1) *General rule.* In the case of a corporation, there shall be allowed as a deduction an amount equal to the sum of:

(i) Losses sustained during the taxable year from sales or exchanges of capital assets, plus

(ii) The aggregate of all losses sustained in other taxable years which are treated as a short-term capital loss in such taxable year pursuant to section 1212(a)(1),

but only to the extent of gains from such sales or exchanges of capital assets in such taxable year.

(2) *Banks.* See section 582(c) for modification of the limitation under section 1211(a) in the case of a bank, as defined in section 581.

(b) *Taxpayers other than corporations*—(1) *General rule.* In the case of a taxpayer other than a corporation, there shall be allowed as a deduction an amount equal to the sum of:

(i) Losses sustained during the taxable year from sales or exchanges of capital assets, plus

(ii) The aggregate of all losses sustained in other taxable years which are treated either as a short-term capital loss or as a long-term capital loss in such taxable year pursuant to section 1212(b), but only to the extent of gains from sales or exchanges of capital assets in such taxable year, plus (if such losses exceed such gains) the additional allowance or transitional additional allowance deductible under section 1211(b) from ordinary income for such taxable year. The additional allowance deductible under section 1211(b) shall

be determined by application of subparagraph (2) of this paragraph, and the transitional additional allowance by application of subparagraph (3) of this paragraph.

(2) *Additional allowance.* Except as otherwise provided by subparagraph (3) of this paragraph, the additional allowance deductible under section 1211(b) for taxable years beginning after December 31, 1969, shall be the least of:

(i) The taxable income for the taxable year reduced, but not below zero, by the zero bracket amount (in the case of taxable years beginning before January 1, 1977, the taxable income for the taxable year);

(ii) $3,000 ($2,000 for taxable years beginning in 1977; $1,000 for taxable years beginning before January 1, 1977); or

(iii) The sum of the excess of the net short-term capital loss over the net long-term capital gain, plus one-half of the excess of the net long-term capital loss over the net short-term capital gain.

(3) *Transitional additional allowance*—(i) *In general.* If, pursuant to the provisions of §1.1212–1(b) and subdivision (iii) of this subparagraph, there is carried to the taxable year from a taxable year beginning before January 1, 1970, a long-term capital loss, and if for the taxable year there is an excess of net long-term capital loss over net short-term capital gain, then, in lieu of the additional allowance provided by subparagraph (2) of this paragraph, the transitional additional allowance deductible under section 1211(b) shall be the least of:

(*a*) The taxable income for the taxable year reduced, but not below zero, by the zero bracket amount (in the case of taxable years beginning before January 1, 1977, the taxable income for the taxable year);

(*b*) $3,000 ($2,000 for taxable years beginning in 1977; $1,000 for taxable years beginning before January 1, 1977); or

(*c*) The sum of the excess of the net short-term capital loss over the net long-term capital gain; that portion of the excess of the net long-term capital loss over the net short-term capital gain computed as provided in subdivision (ii) of this subparagraph; plus one-half of the remaining portion of the excess of the net long-term capital loss over the net short-term capital gain.

(ii) *Computation of specially treated portion of excess long-term capital loss over net short-term capital gain.* In determining the transitional additional allowance deductible as provided by this subparagraph, there shall be applied thereto in full on a dollar-for-dollar basis the excess of net long-term capital loss over net short-term capital gain (computed with regard to capital losses carried to the taxable year) to the extent that the long-term capital losses carried to the taxable year from taxable years beginning before January 1, 1970, as provided by §1.1212–1(b) and subdivision (iii) of this subparagraph, exceed the sum of (*a*) the portion of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) actually realized in the taxable year (i.e., computed without regard to capital losses carried to the taxable year) which consists of net long-term capital gain actually realized in the taxable year, plus (*b*) the amount by which the portion of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) actually realized in the taxable year (i.e., computed without regard to capital losses carried to the taxable year) which consists of net short-term capital gain actually realized in the taxable year exceeds the total of short-term capital losses carried to the taxable year from taxable years beginning before January 1, 1970, as provided by §1.1212–1(b) and subdivision (iv) of this subparagraph.

The amount by which the net long-term capital losses carried to the taxable year from taxable years beginning before January 1, 1970, exceeds the sum of (*a*) plus (*b*) shall constitute the *transitional net long-term capital loss component* for the taxable year for the purpose of this subparagraph.

(iii) *Carryover of certain long-term capital losses not utilized in computation of transitional additional allowance.* If for a taxable year beginning after December 31, 1969, the transitional net long-term capital loss component determined as provided in subdivision (ii) of this subparagraph exceeds the amount of such component applied to the transitional additional allowance for the taxable

year as provided by subdivision (i) of this subparagraph and subparagraph (4)(ii) of this paragraph, then such excess shall for the purposes of this subparagraph be carried to the succeeding taxable year as long-term capital losses from taxable years beginning before January 1, 1970, for utilization in the computation of the transitional additional allowance in the succeeding taxable year as provided in subdivisions (i) and (ii) of this subparagraph. In no event, however, shall the amount of such component carried to the following taxable year as otherwise provided by this subdivision exceed the total of net long-term capital losses actually carried to such succeeding taxable year pursuant to section 1212(b) and § 1.1212–1(b).

(iv) *Carryover of certain short-term capital losses not utilized in computation of additional allowance or transitional additional allowance.* If for a taxable year beginning after December 31, 1969, the total short-term capital losses carried to such year from taxable years beginning before January 1, 1970, as provided by § 1.1212–1(b) and this subdivision exceed the sum of:

(*a*) The portion of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) actually realized in the taxable year (i.e., computed without regard to capital losses carried to the taxable year) which consists of net short-term capital gain actually realized in the taxable year, plus

(*b*) The amount by which the portion of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) actually realized in the taxable year (i.e., computed without regard to capital losses carried to the taxable year) which consists of net long-term capital gain actually realized in the taxable year exceeds the total long-term capital losses carried to the taxable year from taxable years beginning before January 1, 1970, as provided in § 1.1212–1(b) and subdivision (iii) of this subparagraph,

then such excess shall constitute the *transitional net short-term capital loss component* for the taxable year, and to the extent such component also exceeds the net short-term capital loss applied to the additional allowance (as provided in subparagraphs (2) and (4)(i) of this paragraph) or the transitional additional allowance (as provided by subdivision (i) of this subparagraph and subparagraph (4)(i) of this paragraph) for the taxable year shall be carried to the succeeding taxable year as short-term capital losses from taxable years beginning before January 1, 1970, for utilization in such succeeding taxable year in the computation of the additional allowance (as provided by subparagraph (2) of this paragraph) or the transitional additional allowance (as provided by subdivision (i) and (ii) of this subparagraph). In no event, however, shall the amount of such component so carried to the following taxable year as otherwise provided by this subdivision exceed the total of net short-term capital losses actually carried to such succeeding taxable year pursuant to section 1212(b) and § 1.1212–1(b).

(v) *Scope of rules.* The rules provided by this subparagraph are for the purpose of computing the amount of the transitional additional allowance deductible for the taxable year pursuant to the provisions of section 1212(b)(3) and this subparagraph. More specifically, their operation permits the limited use of a long-term capital loss carried to the taxable year from a taxable year beginning before December 31, 1969, in full on a dollar-for-dollar basis in computing the transitional additional allowance deductible for the taxable year. These rules have no application to, or effect upon, a determination of the character or amount of capital gain net income (net capital gain for taxable years beginning before January 1, 1977) reportable in the taxable year. See paragraph (b)(1) of this section and § 1.1212–1 for the determination of the amount and character of capital gains and losses reportable in the taxable year. Further, except to the extent that their application may affect the amount of the transitional additional allowance deductible for the taxable year and thus the amount to be treated as short-term capital loss for carryover purposes under section 1212(b) and § 1.1212–1(b)(2), these rules have no effect upon a determination of the character or amount of capital losses carried to or from the taxable year pursuant to section 1212(b) and § 1.1212–1(b).

(4) *Order of application of capital losses to additional allowance or transitional additional allowance.* In applying the excess of the net short-term capital loss over the net long-term capital gain and the excess of the net long-term capital loss over the net short-term capital gain to the additional allowance or transitional additional allowance deductible under section 1211(b) and this paragraph, such excesses shall, subject to the limitations of subparagraph (2) or (3) of this paragraph, be used in the following order:

(i) First, there shall be applied to the additional allowance or transitional additional allowance the excess, if any, of the net short-term capital loss over the net long-term capital gain.

(ii) Second, if such transitional additional allowance exceeds the amount so applied thereto as provided in subdivision (i) of this subparagraph, there shall next be applied thereto as provided in subparagraph (3) of this paragraph the excess, if any, of the net long-term capital loss over the net short-term capital gain to the extent of the transitional net long-term capital loss component for the taxable year computed as provided by subdivision (ii) of subparagraph (3) of this paragraph.

(iii) Third, if such additional allowance or transitional additional allowance exceeds the sum of the amounts so applied thereto as provided in subdivisions (i) and (ii) of this subparagraph, there shall be applied thereto one-half of the balance, if any, of the excess net long-term capital loss not applied pursuant to the provisions of subdivision (ii) of this subparagraph.

(5) *Taxable years beginning prior to January 1, 1970.* For any taxable year beginning prior to January 1, 1970, subparagraphs (2) and (3) of this paragraph shall not apply and losses from sales or exchanges of capital assets shall be allowed as a deduction only to the extent of gains from such sales or exchanges, plus (if such losses exceed such gains) the taxable income of the taxpayer or $1,000, whichever is smaller.

(6) *Special rules.* (i) For purposes of section 1211(b) and this paragraph, taxable income is to be computed without regard to gains or losses from sales or exchanges of capital assets and without regard to the deductions provided in section 151 (relating to personal exemptions) or any deduction in lieu thereof. For example, the deductions available to estates and trusts under section 642(b) are in lieu of the deductions allowed under section 151, and, in the case of estates and trusts, are to be added back to taxable income for the purposes of section 1211(b) and this paragraph.

(ii) For taxable years beginning before January 1, 1976, in case the tax is computed under section 3 and the regulations thereunder (relating to optional tax tables for individuals), the term *taxable income* as used in section 1211(b) and this paragraph shall be read as *adjusted gross income.*

(iii) In the case of a joint return, the limitation under section 1211(b) and this paragraph, relating to the allowance of losses from sales or exchanges of capital assets, is to be computed and the net capital loss determined with respect to the combined taxable income and the combined capital gains and losses of the spouses.

(7) *Married taxpayers filing separate returns*—(i) *In general.* In the case of a husband or a wife who files a separate return for a taxable year beginning after December 31, 1969, the $3,000, $2,000, and $1,000 amounts specified in subparagraphs (2)(ii) and (3)(i)(*b*) of this paragraph shall instead be $1,500, $1,000, and $500, respectively.

(ii) *Special rule.* If, pursuant to the provisions of § 1.1212–1(b) and subparagraph (3) (iii) or (iv) of this paragraph, there is carried to the taxable year from a taxable year beginning before January 1, 1970, a short-term capital loss or a long-term capital loss, the $1,500, $1,000 and $500 amounts specified in subdivision (i) of this subparagraph shall instead be maximum amounts of $3,000, $2,000, and $1,000 respectively, equal to $1,500, $1,000, and $500, respectively, plus the total of the transitional net long-term capital loss component for the taxable year computed as provided by subparagraph (3)(ii) of this paragraph and the transitional net short-term capital loss component for the taxable year computed as provided by subparagraph (3)(iv) of this paragraph.

(8) *Examples*. The provisions of section 1211(b) may be illustrated by the following examples:

Example 1. A, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1970:

Taxable income exclusive of capital gains and losses		$4,400
Deduction provided by section 151		625
Taxable income for purposes of section 1211(b)		5,025
Long-term capital gain	$1,200	
Long-term capital loss	(5,300)	
Net long-term capital loss	(4,100)	
Losses to the extent of gains	(1,200)	
Additional allowance deductible under section 1211(b)		1,000

The net long-term capital loss of $4,100 is deductible in 1970 only to the extent of an additional allowance of $1,000 which is smaller than the taxable income of $5,025. Under section 1211(b) and subparagraph (2) of this paragraph, $2,000 of excess net long-term capital loss was required to produce the $1,000 additional allowance. Therefore, a net long-term capital loss of $2,100 ($4,100 minus $2,000) is carried over under section 1212(b) to the succeeding taxable year. If A had the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions in 1977, the additional allowance would be $2,000, and a net long-term capital loss of $100 would be carried over. For a taxable year beginning in 1978 or thereafter, these facts would give rise to a $2,050 additional allowance and no carryover.

Example 2. B, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1970:

Taxable income exclusive of capital gains and losses	$90	
Deduction provided by section 151	625	
Taxable income for purposes of section 1211(b)	715	
Long-term capital gain	$1,200	
Long-term capital loss	(5,200)	
Net long-term capital loss	(4,000)	
Losses to the extent of gains	(1,200)	
Additional allowance deductible under section 1211(b)		715

The net long-term capital loss of $4,000 is deductible in 1970 only to the extent of an additional allowance of $715, since the $715 of taxable income for purposes of section 1211(b) is smaller than $1,000. Under section 1211(b) and subparagraph (2) of this paragraph, $1,430 of net long-term capital loss was required to produce the $715 additional allowance. Therefore, a net long-term capital loss of $2,570 ($4,000 minus $1,430) is carried over under section 1212(b) to the succeeding taxable year. For illustration of the result if the net capital loss for the taxable year is smaller than both $1,000 and taxable income for the purposes of section 1211(b), see examples (3) and (4) of this subparagraph. For carryover of a net capital loss, see § 1.1212–1. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transations for taxable years beginning in 1977 or thereafter, the same result would be reached.

Example 3. A, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1971:

Taxable income exclusive of capital gains and losses	$13,300	
Deduction provided by section 151	675	
Taxable income for purposes of section 1211(b)	13,975	
Long-term capital gain	$400	
Long-term capital loss	($600)	
Net long-term capital loss	(200)	
Short-term capital gain	900	
Short-term capital loss	(1,400)	
Net short-term capital loss	(500)	
Losses to extent of gains	(1,300)	
Additional allowance deductible under section 1211(b)		$600

The $600 additional allowance deductible under section 1211(b) is the least of: (i) Taxable income of $13,975, (ii) $1,000, or (iii) the sum of the excess of the net short-term capital loss of $500 over the net long-term capital gain, plus one-half of the excess of the net long-term capital loss of $200 over the net short-term capital gain. The $600 additional allowance, therefore, consists of the net short-term capital loss of $500, plus $100 (one-half of the net long-term capital loss of $200), the total of which is smaller than both $1,000 and taxable income for purposes of section 1211(b). No amount of net capital loss remains to be carried over under section 1212(b) to the succeeding taxable year since the entire amount of the net short-term capital loss of $500 plus the entire amount of the net long-term capital loss of $200 required to produce $100 of the deduction was absorbed by the additional allowance deductible under section 1211(b) for 1971. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the result would remain unchanged.

Example 4. A, a married individual filing a separate return with one exemption allowable as a deduction under section 151, has the following transactions in 1971:

Taxable income exclusive of capital gains and losses	$12,000	
Deduction provided by section 151	675	
Taxable income for purposes of section 1211(b)	12,675	
Long-term capital loss	($800)	
Long-term capital gain	300	
Net long-term capital loss	(500)	
Short-term capital loss	(500)	
Short-term capital gain	600	
Net short-term capital gain	100	
Losses to the extent of gains		(900)
Additional allowance deductible under section 1211(b)		200

The excess net long-term capital loss of $400 (net long-term capital loss of $500 minus net short-term capital gain of $100) is deductible in 1971 only to the extent of an additional allowance of $200 (one-half of $400) which is smaller than both $500 (married taxpayer filing a separate return for a taxable year beginning after December 31, 1969) and taxable income for purposes of section 1211(b). Since there is no net short-term capital loss in excess of net long-term capital gains for the taxable year, the $200 additional allowance deductible under section 1211(b) consists entirely of excess net long-term capital loss. No amount of net capital loss remains to be carried over under section 1212(b) to the succeeding taxable year. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the result would remain unchanged.

Example 5. A, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1970:

Taxable income exclusive of capital gains and losses	$13,300
Deduction provided by section 151	625
Taxable income for purposes of section 1211(b)	13,925
Long-term capital loss	($6,000)
Long-term capital gain	2,000
Net long-term capital loss	(4,000)
Short-term capital gain	3,000
Short-term capital loss carried to 1970 from 1969 under section 1212(b)(1)	(3,000)
Net short-term capital loss	0
Losses to the extent of gains	(5,000)
Additional allowance deductible under section 1211(b)	1,000

The $1,000 additional allowance deductible under section 1211(b) is the least of (i) taxable income of $13,925, (ii) $1,000, or (iii) the sum of the net short-term capital loss ($0) plus one-half of the net long-term capital loss of $4,000. The $1,000 additional allowance, therefore, consists of net long-term capital loss. Since $2,000 of the net long-term capital loss of $4,000 was required to produce the $1,000 additional allowance, the $2,000 balance of the net long-term capital loss is carried over under section 1212(b) to 1971. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the additional allowance would be $2,000, and there would be no carryover.

Example 6. A, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1970:

Taxable income exclusive of capital gains and losses		$13,300
Deduction provided by section 151		625
Taxable income for purposes of section 1211(b)		13,925
Long-term capital gain	$5,000	
Long-term capital loss	(7,000)	
Long-term capital loss carried to 1970 from 1969 under section 1212 (b)(1)	(500)	
Net long-term capital Loss	(2,500)	
Short-term capital gain	1,100	
Short-term capital loss	(1,400)	
Net short-term capital loss	(300)	
Losses to extent of gains	(6,100)	
Transitional additional allowance deductible under section 1211(b)	1,000	

Because a component of the net long-term capital loss for 1970 is a $500 long-term capital loss carried to 1970 from 1969, the transitional additional allowance deductible under section 1211(b) and subparagraph (3) of this paragraph is the least of (i) taxable income of $13,925, (ii) $1,000 or (iii) the sum of the net short-term capital loss of $300, plus the net long-term capital loss for 1970, to the extent of the $500 long-term capital loss carried to 1970 from 1969 and one-half of the $2,000 balance of the net long-term capital loss. The entire $500 long-term capital loss carried to 1970 from 1969 is applicable in full to the transitional additional allowance because there was no net capital gain (capital gain net income for taxable years beginning after December 31, 1976) actually realized in 1970. The $1,000 transitional additional allowance, therefore, consists of the net short-term capital loss of $300, the $500 long-term capital loss carried to 1970 from 1969, plus one-half of enough of the balance of the 1970 net long-term capital loss ($400) to make up the $200 balance of the $1,000 transitional additional allowance. A long-term capital loss of $1,600 ($2,500 minus $900), all of which is attributable to 1970, is carried over under section

1212(b) to 1971. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the transitional additional allowance would be $1,800. No amount would remain to be carried over to the succeeding taxable year.

Example 7. A, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1970:

Taxable income exclusive of capital gains and losses		$13,300
Deduction provided by section 151		625
Taxable income for purposes of section 1211(b)		13,925
Long-term capital loss	($2,000)	
Long-term capital loss carried to 1970 from 1969 under section 1212 (b)(1)	(500)	
Net long-term capital loss	(2,500)	
Short-term capital gain	2,600	
Short-term capital loss carried to 1970 from 1969 under section 1212 (b)(1)	(3,000)	
Net short-term capital loss	(400)	
Losses to the extent of gains	(2,600)	
Transitional additional allowance deductible under section 1211(b)	1,000	

Because a component of the net long-term capital loss for 1970 is a $500 long-term capital loss carried to 1970 from 1969, the transitional additional allowance deductible under section 1211(b) and subparagraph (3) of this paragraph is the least of (i) taxable income of $13,925, (ii) $1,000, or (iii) the sum of the net short-term capital loss of $400, plus the net long-term capital loss for 1970 to the extent of the $500 long-term capital loss carried to 1970 from 1969, and one-half of the $2,000 balance of the net long-term capital loss. The entire $500 long-term capital loss carried to 1970 from 1969 is applicable in full to the transitional additional allowance because the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for the taxable year (computed without regard to capital losses carried to the taxable year) consisted entirely of net short-term capital gain not in excess of the short-term capital loss carried to 1970 from 1969. The $1,000 transitional additional allowance, therefore, consists of the net short-term capital loss of $400, the $500 long-term capital loss carried to 1970 from 1969, plus one-half of enough of the balance of the 1970 net long-term capital loss ($200) to make up the $100 balance of the $1,000 transitional additional allowance. A long-term capital loss of $1,800 ($2,500 minus $700), all of which is attributable to 1970, is carried over under section 1212(b) to 1971. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the transitional additional allowance would be $1,900. No amount would remain to be carried over to the succeeding taxable year.

Example 8. Assume the facts in Example (7) but assume that the individual with one exemption allowable as a deduction under section 151 is married and files a separate return for 1970. The maximum transitional additional allowance to which the individual would be entitled for 1970 pursuant to subparagraph (7)(ii) of this paragraph would be the sum of $500 plus (i) $2,400 of the short-term capital loss of $3,000 carried to 1970 from 1969 (the amount by which such carryover exceeds the $600 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) actually realized in 1970, all of which is net short-term capital gain) and (ii) the $500 long-term capital loss carried to 1970 from 1969. However, since this sum ($3,400) exceeds $1,000, the maximum transitional additional allowance to which the individual is entitled for 1970 is limited to $1,000. If for 1971, the same married individual had taxable income of $13,925 for purposes of section 1211(b) and no capital transactions, and filed a separate return, the additional allowance deductible under section 1211(b) for 1971 would be limited to $500 by reason of subdivision (i) of subparagraph (7) of this paragraph, since, as illustrated in Example 7, no part of the capital loss carried over to 1971 under section 1212 (b) is attributable to 1969. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions as in example (7) for a married individual filing a separate return for a taxable year beginning in 1977 or thereafter, the transitional additional allowance would be $1,900. No amount would remain to be carried over to the succeeding taxable year.

Example 9. B, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1971:

Taxable income exclusive of capital gains and losses		$10,000
Deductions provided by section 151		675
Taxable income for purposes of section 1211(b)		10,675
Long-term capital gain	$2,500	
Long-term capital loss treated under § 1.1211–1 (b)(3)(iii) as carried over from 1969	(5,000)	
Net long-term capital loss	(2,500)	
Short-term capital gain	2,700	
Short-term capital loss carried to 1971 from 1970 under section 1212 (b)(1)	(1,000)	

Short-term capital loss treated under § 1.1211–1 (b)(3)(iv) as carried over from 1969	($2,000)
Net short-term capital loss	(300)
Losses to extent of gain	(5,200)
Transitional additional allowance deductible under section 1211(b)	1,000

Because a component of the net long-term capital loss for 1971 is a long-term capital loss treated under subparagraph (3)(iii) of this paragraph as carried over from 1969, the rules for computation of the transitional additional allowance under subparagraph (3) (i) and (ii) of this paragraph apply. The *transitional net long-term capital loss component* for 1971 under subparagraph (3)(ii) of this paragraph is $1,800, that is, the amount by which the $5,000 long-term loss treated as carried over from 1969 to 1971 exceeds (a) the net long-term capital gain of $2,500 actually realized in 1971 plus (b) the $700 excess of the $2,700 net short-term capital gain actually realized in 1971 over the $2,000 short-term capital loss treated as carried over to 1971 from 1969. The transitional additional allowance for 1971 consists of the $300 net short-term capital loss plus $700 of the net long-term capital loss attributable to 1969. A net long-term capital loss of $1,800 ($2,500 minus $700) is carried over to 1972 under section 1212(b). Only $1,100 of the $1,800 will be treated in 1972 as carried over from 1969 since under subparagraph (3)(iii) of this paragraph the *transitional net long-term capital loss component* of $1,800 is reduced by the amount ($700) applied to the transitional additional allowance for 1971. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for a taxable year beginning in 1977, the transitional additional allowance would be $2,000. A net long-term capital loss of $800 would remain to be carried over. Of this amount $100 would be treated as carried over from 1969. Assuming the original facts for a taxable year beginning in 1978, the transitional additional allowance would be $2,450. No amount would remain to be carried over to the succeeding taxable year.

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§ 1.1212–1 Capital loss carryovers and carrybacks.

(a) *Corporations; other taxpayers for taxable years beginning before January 1, 1964*—(1) *Regular net capital loss sustained for taxable years beginning before January 1, 1970.* (i) A corporation sustaining a net capital loss for any taxable year beginning before January 1, 1970, and a taxpayer other than a corporation sustaining a net capital loss for any taxable year beginning before January 1, 1964, shall carry over such net loss to each of the 5 succeeding taxable years and treat it in each of such 5 succeeding taxable years as a short-term capital loss to the extent not allowed as a deduction against any net capital gains (capital gain net income for taxable years beginning after December 31, 1976) of any taxable years intervening between the taxable year in which the net capital loss was sustained and the taxable year to which carried. The carryover is thus applied in each succeeding taxable year to offset any net capital gain in such succeeding taxable year. The amount of the capital loss carryover may not be included in computing a new net capital loss of a taxable year which can be carried over to the next 5 succeeding taxable years. For purposes of this subparagraph, a net capital gain (capital gain net income for taxable years beginning after December 31, 1976) shall be computed without regard to capital loss carryovers or carrybacks. In the case of nonresident alien individuals, see section 871 for special rules on capital loss carryovers. For the rules applicable to the portion of a net capital loss of a corporation which is attributable to a foreign expropriation capital loss sustained in taxable years beginning after December 31, 1958, see subparagraph (2) of this paragraph. For the rules applicable to a taxpayer other than a corporation in the treatment of that amount of a net capital loss which may be carried over under section 1212 and this subparagraph as a short-term capital loss to the first taxable year beginning after December 31, 1963, see paragraph (b) of this section.

(ii) The practical operation of the provisions of this subparagraph may be illustrated by the following example:

Example: (a) For the taxable years 1952 to 1956, inclusive, an individual with one exemption allowable under section 151 (or corresponding provision of prior law) is assumed to have a net short-term capital loss, net short-term capital gain, net long-term capital loss, net long-term capital gain, and taxable income (net income for 1952 and 1953) as follows:

	1952	1953	1954	1955	1956
Carryover from prior years:					
From 1952	.....	($50,000)	($29,500)	($29,500)	.....
From 1954	.....	.....	.....	(19,500)	($13,000)
Net short-term loss (computed without regard to the carryovers)	($30,000)	(5,000)	(10,000)	.....	.....
Net short-term gain (computed without regard to the carryovers)	.....	.....	.....	40,000	.....
Net long-term loss	(20,500)	.....	(10,000)	(5,000)	.....
Net long-term gain	.....	25,000	.....	.....	15,000
Net income or taxable income, computed without regard to capital gains and losses, and, after 1953, without regard to the deduction provided by section 151	500	500	500	1,000	500
Net capital gain (capital gain net income for taxable years beginning after December 31, 1976) (computed without regard to the carryovers)	.....	20,500	.....	36,000	.....
Net capital loss	(50,000)	.....	(19,500)	.....	.....
Deduction allowable under section 1202	.....	.....	.....	.....	1,000
Taxable income (after deductions allowable under sections 151 and 1202)	.....	.....	.....	.....	900

(b) *Net capital loss of 1952.* The net capital loss is $50,000. This figure is the excess of the losses from sales or exchanges of capital assets over the sum of (1) gains (in this case, none) from sales or exchanges of capital assets, and (2) net income (computed without regard to capital gains and losses) of $500. This amount may be carried forward in full as a short-term loss to 1953. However, in 1953 there was a net capital gain (capital gain net income for taxable years beginning after December 31, 1976) of $20,500, as defined by section 117(a)(10)(B) of the Internal Revenue Code of 1939, and limited by section 117(e)(1) of the 1939 Code, against which this net capital loss of $50,000 is allowed in part. The remaining portion—$29,500—may be carried forward to 1954 and 1955 since there was no net capital gain (capital gain net income for taxable years beginning after December 31, 1976) in 1954. In 1955 this $29,500 is allowed in full against net capital gain of $36,000, as defined by paragraph (d) of § 1.1222–1 and limited by subdivision (i) of this subparagraph.

(c) *Net capital loss of 1954.* The net capital loss is $19,500. This figure is the excess of the losses from sales or exchanges of capital assets over the sum of (1) gains (in this case, none) from sales or exchanges of capital assets and (2) taxable income (computed without regard to capital gains and losses and the deductions provided in section 151) of $500. This amount may be carried forward in full as a short-term loss to 1955. The net capital gain (capital gain net income for taxable years beginning after December 31, 1976) in 1955, before deduction of any carryovers, is $36,000. (See sections 1222(9)(B) and 1212 of the Internal Revenue Code of 1954, as it existed prior to the enactment of the Revenue Act of 1964.) The $29,500 balance of the 1952 loss is first applied against the $36,000, leaving a balance of $6,500. Against this amount the $19,500 loss arising in 1954 is applied, leaving a loss of $13,000, which may be carried forward to 1956. Since this amount is treated as a short-term capital loss in 1956 under subdivision (i) of this subparagraph, the excess of the net long-term capital gain over the net short-term capital loss is $2,000 ($15,000 minus $13,000). Half of this excess is allowable as a deduction under section 1202. Thus, after also deducting the exemption allowed as a deduction under section 151 ($600), the taxpayer has a taxable income of $900 ($2,500 minus $1,600) for 1956.

(2) *Corporations sustaining foreign expropriation capital losses for taxable years ending after December 31, 1958*—(i) *In general.* A corporation sustaining a net capital loss for any taxable year ending after December 31, 1958, any portion of which is attributable to a foreign expropriation capital loss, shall carry over such portion of the loss to each of the ten succeeding taxable years and treat it in each of such succeeding taxable years as a short-term capital loss to the extent and consistent with the manner provided in subparagraph (1) of this paragraph. For such purposes, the portion of any net capital loss for any taxable year which is attributable to a foreign expropriation capital loss is the amount, not in excess of the net capital loss for such year, of the foreign expropriation capital loss for such year. The portion of a net capital loss for any taxable year which is attributable to a foreign expropriation capital loss shall be treated as a separate net capital loss for that

year and shall be applied, after first applying the remaining portion of such net capital loss, to offset any capital gain net income (net capital gain for taxable years beginning before January 1, 1977) in a succeeding taxable year. In applying net capital losses of two or more taxable years to offset the capital gain net income (net capital gain(s) for taxable years beginning before January 1, 1977) of a subsequent taxable year, such net capital losses shall be offset against such capital gain net income (net capital gain(s) for taxable years beginning before January 1, 1977) in the order of the taxable years in which the losses were sustained, beginning with the loss for the earliest preceding taxable year, even though one or more of such net capital losses are attributable in whole or in part to a foreign expropriation capital loss.

(ii) *Foreign expropriation capital loss defined*. For purposes of this subaparagraph the term *foreign expropriation capital loss* means, for any taxable year, the sum of the losses taken into account in computing the net capital loss for such year which are:

(*a*) Losses sustained directly by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing, or

(*b*) Losses (treated under section 165 (g)(1) as losses from the sale or exchange of capital assets) from securities which become worthless by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing.

(iii) *Illustrations*. The application of this subparagraph may be illustrated by the following examples:

Example 1. X, a domestic corporation which uses the calendar year as the taxable year, owns as a capital asset 75 percent of the outstanding stock of Y, a foreign corporation operating in a foreign country. In 1961, the foreign country seizes all of the assets of Y, rendering X's stock in Y worthless and thus causing X to sustain a $40,000 foreign expropriation capital loss for such year. In 1961, X has $30,000 of other losses from the sale or exchange of capital assets and $50,000 of gains from the sale or exchange of capital assets. X's net capital loss for 1961 is $20,000 ($70,000 − $50,000). Since the foreign expropriation capital loss exceeds this amount, the entire $20,000 is a foreign expropriation capital loss for 1961.

Example 2. Z, a domestic corporation which uses the calendar year as the taxable year, has a net capital loss of $50,000 for 1961, $30,000 of which is attributable to a foreign expropriation capital loss. Pursuant to the provisions of this paragraph, $30,000 of such net capital loss shall be carried over as a short-term capital loss to each of the 10 taxable years succeeding 1961, and the remaining $20,000 of the net capital loss shall be carried over as a short-term capital loss to each of the 5 taxable years succeeding 1961. Z has a $35,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) (determined without regard to any capital loss carryover) for 1962. In offsetting the $50,000 capital loss carryover from 1961 against the $35,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for 1962, the $30,000 portion of such carryover which is attributable to the foreign expropriation capital loss for 1961 is applied against the 1962 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) after applying the $20,000 remaining portion of the carryover. Thus, there is a capital loss carryover of $15,000 to 1963, all of which is attributable to the foreign expropriation capital loss for 1961. Z has a net capital loss for 1963 of $10,000, no portion of which is attributable to a foreign expropriation capital loss. For 1964, Z has a net capital gain (capital gain net income for taxable years beginning after December 31, 1976) of $22,000 (determined without regard to the capital loss carryovers from 1961 and 1963). In offsetting the capital loss carryovers from 1961 and 1963 against Z's $22,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for 1964, the $15,000 carryover from 1961 is applied against the 1964 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) before the $10,000 capital loss carryover from 1963 is applied against such gain. Thus, $3,000 of the 1963 net capital loss remains to be carried over to 1965.

(3) *Regular net capital loss sustained by a corporation for taxable years beginning after December 31, 1969*—(i) *General rule*. A corporation sustaining a net capital loss for any taxable year beginning after December 31, 1969 (hereinafter in this paragraph referred to as the *loss year*), shall:

(*a*) Carry back such net capital loss to each of the 3 taxable years preceding

the loss year, but only to the extent that such net capital loss is not attributable to a foreign expropriation capital loss and the carryback of such net capital loss does not increase or produce a net operating loss (as defined in section 172(c)) for the taxable year to which it is carried back; and

(*b*) Carry over such net capital loss to each of the 5 taxable years succeeding the loss year,

and, subject to subdivision (ii) of this subparagraph, treat such net capital loss in each of such 3 preceding and 5 succeeding taxable years as a short-term capital loss.

(ii) *Amount treated as a short-term capital loss in each year.* The entire amount of the net capital loss for any loss year shall be carried to the earliest of the taxable years to which such net capital loss may be carried, and the portion of such net capital loss which shall be carried to each of the other taxable years to which such net capital loss may be carried shall be the excess, if any, of such net capital loss over the total of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (computed without regard to the capital loss carryback from the loss year or any taxable year thereafter) for each of the prior taxable years to which such net capital loss may be carried.

(iii) *Special rules. (a)* In the case of a net capital loss which is not a foreign expropriation capital loss and which cannot be carried back in full to a preceding taxable year by reason of section 1212(a)(1)(A)(ii) and subdivision (i)(*a*) of this subparagraph because such loss would produce or increase a net operating loss in such preceding taxable year, the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such preceding taxable year shall in no case be treated as greater than the amount of such net capital loss which can be carried back to such preceding taxable year upon the application of section 1212(a)(1)(A)(ii) and subdivision (i)(*a*) of this subparagraph.

(*b*) For the rules applicable to the portion of a net capital loss of a corporation which is attributable to a foreign expropriation capital loss sustained in a taxable year beginning after December 31, 1958, see section 1212(a)(2) and subparagraph (2) of this paragraph.

(*c*) Section 1212(a)(1)(A) and subdivision (*i*)(*a*) of this subparagraph shall not apply to (and no carryback shall be allowed with respect to) the net capital loss of a corporation for any taxable year for which such corporation is an electing small business corporation under subchapter S. See § 1.1372–1.

(*d*) A net capital loss of a corporation for a year for which it is not an electing small business corporation under subchapter S shall not be carried back under section 1212(a)(1)(A) and subdivision (i)(*a*) of this subparagraph to a taxable year for which such corporation is an electing small business corporation. See section 1212(a)(3).

(*e*) A net capital loss of a corporation shall not be carried back under section 1212(a)(1)(A) and subdivision (i)(*a*) of this subparagraph to a taxable year for which the corporation was a foreign personal holding company, a regulated investment company, or a real estate investment trust, or for which an election made by the corporation under section 1247 is applicable. See section 1212(a)(4).

(*f*) A taxable year to which a net capital loss of a corporation cannot, by reason of (*d*) or (*e*) of this subdivision, be carried back under section 1212(a)(1)(A) and subdivision (i)(*a*) of this subparagraph shall nevertheless be treated as 1 of the 3 taxable years preceding the loss year for purposes of section 1212(a)(1)(A) and such subdivision (i)(*a*); but any capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such taxable year to which such net capital loss cannot be carried back shall be disregarded for purposes of subdivision (ii) of this subparagraph.

(*g*) A regulated investment company (as defined in section 851) sustaining a net capital loss shall carry over that loss to each of the 8 taxable years succeeding the loss year. However, the 8-year period prescribed in the preceding sentence shall be reduced (but not to less than 5 years) by the sum of (*1*) the number of taxable years to which the net capital loss must be carried back pursuant to subdivision (i)(*a*) of this

subparagraph (as limited by subdivision (iii)(*e*) of this subparagraph) and (*2*) the number of taxable years, of the 8 taxable year succeeding the loss year, that the corporation failed to qualify as a regulated investment company as defined in section 851. This subdivision shall not extend the carryover period prescribed in subdivision (i)(*b*) of this subparagraph to a year in which a corporation is not a regulated investment company as defined in section 851.

(iv) The application of this subparagraph may be illustrated by the following examples, in each of which it is assumed that the corporation is not, and never has been, a corporation described in subdivision (iii) (*c*) or (*d*) of this subparagraph, that the corporation files its tax returns on a calendar year basis, and that no capital loss sustained is a foreign expropriation capital loss:

Example 1. A corporation has a net capital loss for 1970 which section 1212(a)(1)(A) permits to be carried back. The entire net capital loss for 1970 may be carried back to 1967, but only to the extent that a net operating loss for 1967 would not be produced or increased. The amount of the carryback to 1968 is the excess of the net capital loss for 1970 over the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for 1967, computed without regard to a capital loss carryback from 1970 or any taxable year thereafter. The amount of the carryback to 1969 is the excess of the net capital loss for 1970 over the sum of the net capital gains (capital gain net income for taxable years beginning after December 31, 1976) for 1967 and 1968, computed without regard to a capital loss carryback from 1970 or any taxable year thereafter. The amount of the carryover to 1971 is the excess of the net capital loss for 1970 over the sum of the net capital gains (capital gain net income for taxable years beginning after December 31, 1976) for 1967, 1968, and 1969, computed without regard to a capital loss carryback from 1970 or any taxable year thereafter. Similarly, the amount of the carryover to 1972, 1973, 1974, and 1975, respectively, is the excess of the net capital loss for 1970 over the sum of the net capital gains (capital gain net income for taxable years beginning after December 31, 1976) for taxable years prior to 1972, 1973, 1974, or 1975, as the case may be, to which the net capital loss for 1970 may be carried, computed without regard to a capital loss carryback from 1970 or any year thereafter.

Example 2. For the taxable years 1967 to 1975, inclusive, a corporation is assumed to have net capital loss, net capital gain (capital gain net income for taxable years beginning after December 31, 1976), and taxable income (computed without regard to capital gains and losses) as follows:

	1967	1968	1969	1970	1971	1972	1973	1974	1975
Taxable income (computed without regard to capital gains or losses)	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000
Net capital loss	.....	.....	(1,000)	(29,500)	(16,000)	(500)	.....	.....	.....
Net capital gain (capital gain net income for taxable years beginning after December 31, 1976) (computed without regard to carrybacks or carryovers)	14,000	16,000	.....	.....	.....	.....	8,000	7,500	6,500
Carryback or carryover:									
From 1969	.....	.....	.....	.....	.....	.....	(1,000)	.....	.....
From 1970	(14,000)	(15,500)	.....	.....	.....	.....	.....	.....	.....
From 1971	.....	(500)	.....	.....	.....	.....	(7,000)	(7,500)	(1,000)
From 1972	.....	.....	.....	.....	.....	.....	.....	.....	(500)

The net capital loss of 1969, under the rules of subparagraph (1) of this paragraph, may not be carried back. Thus, the net capital loss for 1970 is carried back and partially absorbed by the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for 1967, and a portion of the net capital losses of both 1970 and 1971 are carried back to 1968. The net capital loss for 1969 is the oldest that may be carried to 1973, and thus, it is the first carried over and absorbed by the net capital gain for 1973. The net capital loss for 1972 (which is not carried back because of the net capital losses in the 3 years preceding 1972) may be carried over to 1973.

Example 3. For the taxable years 1967 to 1970, inclusive, a corporation which was organized on January 1, 1967, realized operating income and net capital gains (capital gain net income for taxable years beginning

after December 31, 1976) and sustained operating losses and net capital losses as follows:

	Operating income or loss (exclusive of capital gain or loss)	Capital gain or loss
1967	$20,000	$24,000
1968	20,000	0
1969	20,000	0
1970	(25,000)	(20,000)

The net capital loss of $20,000 for 1970 is carried back to 1967 and applied against the $24,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) realized in that year, reducing such net capital gain (capital gain net income for taxable years beginning after December 31, 1976) to $4,000. The net operating loss of $25,000 for 1970 is then carried back to 1967 and applied first to eliminate the $20,000 of operating income for that year and then to eliminate the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for that year of $4,000 (as reduced by the 1970 capital loss carryback).

Example 4. Assume the same facts as in Example 3 but substitute the following figures:

	Operating income or loss (exclusive of capital gain or loss)	Capital gain or loss
1967	($20,000)	$24,000
1968	20,000	0
1969	20,000	0
1970	(25,000)	(20,000)

The net capital loss of $20,000 for 1970 is carried back to 1967 and applied against the $24,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) realized in that year only to the extent of $4,000, the maximum amount to which the 1970 capital loss carryback can be applied without producing a net operating loss for 1967. The unused $16,000 balance of the 1970 net long-term capital loss can be carried forward to 1971 and subsequent taxable years to the extent provided in subdivision (i)(*b*) of this subparagraph.

Example 5. Assume the same facts as in Example 3 but substitute the following figures:

	Operating income or loss (exclusive of capital gain or loss)	Capital gain or loss
1967	0	0
1968	($20,000)	0
1969	0	$24,000
1970	20,000	(24,000)

The net capital loss of $24,000 for 1970 is carried back to 1969 and applied against the $24,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) realized in that year to the extent of $24,000. The application of the capital loss carryback is not limited as it was in Example 4 because such carryback neither increases nor produces a net operating loss, as such, for 1969. The $20,000 net operating loss for 1968 is then carried forward to 1970 to eliminate the $20,000 of operating income for that year.

Example 6. Assume the same facts as in Example 3 but substitute the following figures:

	Operating income or loss (exclusive of capital gain or loss)	Capital gain or loss
1967	0	0
1968	0	0
1969	($20,000)	($24,000)
1970	20,000	20,000

The net capital loss of $24,000 for 1969 is carried forward to 1970 and applied against the $20,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) realized in that year. The unused $4,000 balance of the 1969 net capital loss can be carried forward to 1971 and subsequent taxable years to the extent provided in subdivision (i)(*b*) of this subparagraph.

(b) *Taxpayers other than corporations for taxable years beginning after December 31, 1963*—(1) *In general.* If a taxpayer other than a corporation sustains a net capital loss for any taxable year beginning after December 31, 1963, the portion thereof which is a short-term capital loss carryover shall be carried over to the succeeding taxable year and treated as a short-term capital loss sustained in such succeeding taxable year, and the portion thereof which constitutes a long-term capital loss carryover shall be carried over to the succeeding taxable year and treated as a long-term capital loss sustained in such succeeding taxable year. The carryovers are included in the succeeding taxable year in the determination of the amount of the short-term capital loss, the net short-term capital gain or loss, the long-term capital loss, and the net long-term capital gain or loss in such year, the net capital loss in such year, and the capital loss carryovers from such year. For purposes of this subparagraph:

(i) A short-term capital loss carryover is the excess of the net short-term capital loss for the taxable year over the net long-term capital gain for such year, and

(ii) A long-term capital loss carryover is the excess of the net long-term capital loss for the taxable year over the net short-term capital gain for such year.

(2) *Special rules for determining a net short-term capital gain or loss for purposes of carryover*—(i) *Taxable years beginning after December 31, 1963, and before January 1, 1970.* In determining a net short-term capital gain or loss of a taxable year beginning after December 31, 1963, and before January 1, 1970, for purposes of computing a short-term or long-term capital loss carryover to the succeeding taxable year, an amount equal to the additional allowance deductible under section 1211(b) for the taxable year (determined as provided in section 1211(b), as in effect for taxable years beginning before January 1, 1970, and § 1.1211–1(b)(5)) is treated as a short-term capital gain occurring in such year.

(ii) *Taxable years beginning after December 31, 1969.* In determining a net short-term capital gain or loss of a taxable year beginning after December 31, 1969:

(*a*) For purposes of computing a short-term capital loss carryover to the succeeding taxable year, an amount equal to the additional allowance for the taxable year (determined as provided in section 1211(b) and § 1.1211–1(b)(2)) is treated as a short-term capital gain occurring in such year, and

(*b*) For purposes of computing a long-term capital loss carryover to the succeeding taxable year, an amount equal to the sum of the additional allowance for the taxable year (determined as provided in section 1211(b) and § 1.1211–1(b)(2)), plus the excess of such additional allowance over the net short-term capital loss (determined without regard to section 1212(b)(2) for such year) is treated as a short-term capital gain in such year.

The rules provided in this subdivision are for the purpose of taking into account the additional allowance deductible for the current taxable year under section 1211(b) and § 1.1211–1(b)(2) in determining the amount and character of capital loss carryovers from the current taxable year to the succeeding taxable year. Their practical application to a determination of the amount and character of capital loss carryovers from the current taxable year to the succeeding taxable year involves identification of the net long-term and net short-term capital loss components of the additional allowance deductible in the current taxable year as provided by § 1.1211–1(b)(2)(iii). To the extent that the additional allowance is composed of net short-term capital losses, such losses are treated as a short-term capital gain in the current taxable year in determining the capital loss carryovers to the succeeding year. To the extent that the additional allowance is composed of net long-term capital losses applied pursuant to the provisions of § 1.1211–1(b)(2)(iii), an amount equal to twice the amount of such component of the additional allowance is treated as a short-term capital gain in the current taxable year. See paragraph (4) of this section for transitional rules if any part of the additional allowance is composed of net long-term capital losses carried to the current taxable year from a taxable year beginning before January 1, 1970.

(3) *Transitional rule for net capital losses sustained in a taxable year beginning before January 1, 1964.* A taxpayer other than a corporation sustaining a net capital loss for any taxable year beginning before January 1, 1964, shall treat as a short-term capital loss in the first taxable year beginning after December 31, 1963, any amount which would be treated as a short-term capital loss in such year under subchapter P of chapter 1 of the Code as in effect immediately before the enactment of the Revenue Act of 1964.

(4) *Transitional rule for net long-term capital losses sustained in a taxable year beginning before January 1, 1970.* In the case of a net long-term capital loss sustained by a taxpayer other than a corporation in a taxable year beginning prior to January 1, 1970 (referred to in this section as a *pre-1970 taxable year*) which is carried over and treated as a long-term capital loss in the first taxable year beginning after December 31, 1969 (referred to in this section as a *post-1969 taxable year*), the transitional additional allowance deductible under section 1211(b) for the taxable year shall be determined by application of

section 1211(b) as in effect for pre-1970 taxable years and § 1.1211–1(b)(3), and the amount of such long-term capital loss carried over and treated as a long-term capital loss in the succeeding taxable year shall be determined by application of section 1212(b)(1) as in effect for pre-1970 taxable years and subparagraph (2)(i) of this paragraph (instead of under sections 1211(b) and 1212(b)(1) as in effect for post-1969 taxable years and § 1.1211–1(b)(2) and subparagraph (2)(ii) of this paragraph, respectively) but only to the extent that such pre-1970 long-term capital loss constitutes a *transitional net long-term capital loss component* (determined as provided in § 1.1211–1(b)(3)(ii)) in the taxable year to which such pre-1970 long-term capital loss is carried. Thus, for purposes of paragraph (2) of this section, to the extent that a component of the transitional additional allowance deductible for a post-1969 taxable year under section 1211(b) and § 1.1211–1(b)(3)(i) is a transitional net long-term capital loss component carried over to such post-1969 taxable year, such component shall be treated as a short-term capital gain in determining the amount and character of capital loss carryovers from such post-1969 taxable year to the succeeding taxable year. Such component shall be so treated as a short-term capital gain in full on a dollar-for-dollar basis and shall not be doubled for this purpose as is provided by subdivision (ii) of paragraph (2) of this section in the case of a component of the additional allowance made up of net long-term capital losses applied pursuant to the provisions of § 1.1211–1(b)(2)(iii). The transitional rule provided in this paragraph does not apply to a determination of the character of capital losses (as long-term or short-term) actually deductible for the current taxable year under section 1211(b) and § 1.1211–1(b).

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

Example 1. For the taxable year 1971, an unmarried individual has taxable income for purposes of section 1211(b) of $8,000, a long-term capital loss of $2,000, and no other capital gains or losses. $1,000 (one-half) of the net long-term capital loss is deductible in 1971 as the additional allowance deductible under section 1211(b). No amount of capital loss remains to be carried over to the succeeding taxable year.

Example 2. For the taxable year 1972, the same unmarried individual has taxable income for purposes of section 1211(b) of $8,000, a long-term capital loss of $3,000 and no other capital gains or losses. $1,500 (one-half of the excess net capital loss) is deductible in 1972, but limited to the $1,000 maximum additional allowance deductible under section 1211(b). By application of section 1212(b)(1), he will carry over to 1973 a long-term capital loss of $1,000 determined as follows:

Net long-term capital loss		($3,000)
Additional allowance deductible under section 1211(b)	$1,000	
Excess of additional allowance over net short-term capital loss (determined without regard to section 1212(b)(2)(B)(i))	1,000	
Total amount treated as short-term capital gain under 1212(b)(2)(B) for purposes of determining carryover		2,000
Long-term capital loss carryover to 1973		(1,000)

If, in 1973, he had taxable income for purposes of section 1211(b) of $8,000, but no capital gains or losses, $500 (one-half) of the net long-term capital loss carryover from 1972 would be deductible in 1973 as the additional allowance deductible under section 1211(b). No amount of capital loss would be carried over to 1974.

Example 3. For the taxable year 1971, an unmarried individual has taxable income for purposes of section 1211(b) of $9,000, a $500 short-term capital gain, a $700 short-term capital loss, a $1,000 long-term capital gain and a $1,700 long-term capital loss. He will offset $1,500 of capital losses against capital gains. The excess net capital loss of $900 is deductible in 1971 to the extent of a $550 additional allowance deductible under 1211(b) which is smaller than both $1,000 and taxable income for purposes of section 1211(b), determined as follows:

Losses allowed to the extent of gains	($1,500)
Amount allowed under section 1211(b)(1)(C):	
(i) Excess of net short-term capital loss over net long-term capital gain	(200)
(ii) One-half of the excess of net long-term capital loss over net short-term capital gain	(350)
Additional allowance deductible under section 1211(b)	550

The total amount treated as short-term capital gain under section 1212(b)(2)(B) for purposes of determining any carryover to the succeeding taxable year exceeds $900. No amount of net capital loss remains to be carried over to the succeeding taxable year.

Example 4. If in example (3) above, the long-term capital loss had been $2,800, the taxpayer would carry over $200 of long-term capital loss to 1972, determined as follows:

Losses allowed to extent of gains	($1,500)
Amount allowed under section 1211(b)(1) (B) and (C):	
(i) Excess of net short-term capital loss over net long-term capital gain	(200)
(ii) One-half the excess of net long-term capital loss over net short-term capital gain	(900)

as limited by 1211(b)(1)(B) to an additional allowance of $1,000.

Carryover under section 1212(b)(1):	
Net long-term capital loss for 1971	($1,800)
Additional allowance under section 1211(b)(1)(B)	1,000
Excess of additional allowance deductible under section 1211(b) over net short-term capital loss determined without regard to section 1212(b)(2)(B)(i) ($1,000 less $200)	800
Total amount treated as short-term capital gain under section 1212(b)(2)(B) for purposes of determining carryover	1,800
Short-term capital gain for 1971	500
Total short-term capital gain	2,300
Short-term capital loss for 1971	(700)
Net short-term capital gain	1,600
Long-term capital loss carryover ($1,800 less $1,600)	200

Example 5. For 1969, an unmarried individual has taxable income for purposes of section 1211(b) of $8,000, a long-term capital loss of $3,000, and no other capital gains or losses. He is allowed to deduct in 1969 $1,000 as the additional allowance deductible under section 1211(b) (as in effect for pre-1970 taxable years) and to carry over to 1970, a long-term capital loss of $2,000 under section 1212(b) (as in effect for pre-1970 taxable years).

If, in 1970, the same unmarried individual with taxable income for purposes of section 1211(b) of $8,000, has no capital gains or losses, he would deduct $1,000 of his pre- 1970 capital loss carryover as the transitional additional allowance deductible under section 1211(b) (as in effect for pre-1970 years) and carry over under section 1212(b)(1) (as in effect for pre-1970 taxable years) to 1971 the remaining $1,000 as a pre-1970 long-term capital loss.

If, in 1970, the same individual instead has a long-term capital gain of $2,500, and a long-term capital loss of $1,500, he would net these two items with the $2,000 carried to 1970 as a long-term capital loss. Thus, he would have a net long-term capital loss for 1970 of $1,000 which is deductible in 1970 as the transitional additional allowance deductible under section 1211(b). He would have no amount to carry over under section 1212(b)(1) to 1971.

If, in 1970, the same individual instead has a long-term capital loss of $1,200, and a long-term capital gain of $200, resulting in a net long-term capital loss of $3,000 when netted with the $2,000 carried to 1970 as a long-term capital loss, he would deduct $1,000 in respect of his pre-1970 long-term capital loss carryover as the transitional additional allowance deductible under section 1211(b) (as in effect for pre-1970 taxable years) and carry over under section 1212(b)(1) (as in effect for pre-1970 taxable years) to 1971 the remaining $1,000 of the pre-1970 component of his long-term capital loss carryover, and the $1,000 net long-term capital loss actually sustained in 1970 as the second component of his long-term capital loss carryover.

Example 6. For 1970 a married individual filing a separate return has taxable income of $8,000, a long-term capital loss of $3,500 and a short-term capital gain of $3,000. He also has a pre-1970 short-term capital loss of $2,000 which is carried to 1970. The $3,000 short-term capital gain realized in 1970 would first be reduced by the $2,000 short-term capital loss carryover, and then the remaining $1,000 balance of the short-term capital gain would be offset against the $3,500 long-term capital loss, producing a net long-term capital loss of $2,500, no part of which is a net long-term capital loss carried over from 1969. However, under the special rule of § 1.1211–1(b)(7)(ii) in 1970, the taxpayer would deduct as the additional allowance deductible under section 1211(b), the $500 limitation in § 1.1211–1(b)(2)(ii) in the case of a married taxpayer filing a separate return in a taxable year ending after December 31, 1969, plus the *transitional net short-term capital loss component* of $2,000 computed under § 1.1211–1(b)(3)(iv), but limited to a total deduction of $1,000. The $1,000 additional allowance deductible under section 1211(b) would absorb $2,000 of the $2,500 net long-term capital loss, and he would carry the unused $500 balance of such loss to 1971 for use in that year.

Example 7. For 1970, an unmarried individual filing a separate return has taxable income for purposes of section 1211(b) of $8,000, and a long-term capital loss of $2,000. He also has a pre-1970 long-term capital loss of $2,500 which is carried to 1970. In 1970, the taxpayer would deduct as the transitional additional allowance deductible under section 1211(b) $1,000, absorbing $1,000 of the pre-1970 long-term capital loss of $2,500. He would carry to 1971 the unused $1,500 balance of his pre-1970 long-term capital loss plus the 1970 long-term capital loss of $2,000, or a total of $3,500, for use in 1971.

For 1971, the same taxpayer filing a separate return with taxable income for purposes of section 1211(b) of $8,000, has a $3,600 long-term capital gain and a $2,200 long-term capital loss. When these gains and losses are combined with the long-term capital loss carryover from 1970 of $3,500, a net long-term

capital loss of $2,100 results. He would deduct $1,000 as the transitional additional allowance deductible under section 1211(b). The $1,000 additional allowance would absorb $100 of the unused pre-1970 long-term capital loss carryover of $1,500 plus $1,800 of the unused post-1969 long-term capital loss carryover of $2,100 (the amount of the 1971 net long-term capital loss necessary to make up the remaining $900 balance of the additional allowance). Although a component of the 1971 net long-term capital loss is the unused pre-1970 long-term capital loss carryover of $1,500, only $100 of this carryover is available for use in full on a dollar-for-dollar basis in computing the transitional additional allowance for 1971 since it only exceeds by that amount the $1,400 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) actually realized in 1971 all of which is net long-term capital gain (long-term capital gain of $3,600 reduced by long-term capital loss of $2,200). See § 1.1221–1(b)(3)(ii). The taxpayer would carry over to 1972 as a long-term capital loss the remaining $200 of the 1971 long-term capital loss.

Example 8. For 1970, an unmarried individual has taxable income for purposes of section 1211(b) of $8,000 and a short-term capital loss of $700. He also has a pre-1970 long-term capital loss carryover of $1,200. He would deduct $1,000 as the transitional additional allowance deductible under section 1211(b). The $1,000 transitional additional allowance would be composed of the 1970 short-term capital loss of $700 and $300 of the pre-1970 long-term capital loss carryover. He would carry over to 1971 the unused $900 balance of his $1,200 pre-1970 long-term capital loss carryover for use in 1971.

(c) *Husband and wife.* (1) The following rules shall be applied in computing capital loss carryovers by husband and wife:

(i) If a husband and wife making a joint return for any taxable year made separate returns for the preceding year, any capital loss carryovers of each spouse from such preceding taxable year may be carried forward to the taxable year in accordance with paragraph (a) or (b) of this section.

(ii) If a joint return was made for the preceding taxable year, any capital loss carryover from such preceding taxable year may be carried forward to the taxable year in accordance with paragraph (a) or (b) of this section.

(iii) If a husband and wife make separate returns for the first taxable year beginning after December 31, 1963, or any prior taxable year, and they made a joint return for the preceding taxable year, any capital loss carryover from such preceding taxable year shall be allocated to the spouses on the basis of their individual net capital loss which gave rise to such capital loss carryover. The capital loss carryover so allocated to each spouse may be carried forward by such spouse to the taxable year in accordance with paragraph (a) or (b) of this section.

(iv) If a husband and wife making separate returns for any taxable year following the first taxable year beginning after December 31, 1963, made a joint return for the preceding taxable year, any long-term or short-term capital loss carryovers shall be allocated to the spouses on the basis of their individual net long-term and net short-term capital losses for the preceding taxable year which gave rise to such capital loss carryovers, and the portions of the long-term or short-term capital loss carryovers so allocated to each spouse may be carried forward by such spouse to the taxable year in accordance with paragraph (b) of this section.

(v) If separate returns are made both for the taxable year and the preceding taxable year, any capital loss carryover of each spouse may be carried forward by such spouse in accordance with paragraph (a) or (b) of this section.

(2) The provisions of subparagraph (1) (i), (iii), and (iv) of this paragraph may be illustrated by the following examples:

Example 1. If H and W, husband and wife, make a joint return for 1955, having made separate returns for 1954 in which H had a net capital loss of $3,000 and W had a net capital loss of $2,000, in their joint return for 1955 they would have a short-term capital loss of $5,000 (the sum of their separate capital loss carryovers from 1954), allowable in accordance with paragraph (a) of this section. If, on the other hand, they make separate returns in 1955 following a joint return in 1954 in which their net capital loss was $5,000 allocable $3,000 to H and $2,000 to W, the carryover of H as a short-term capital loss for the purpose of his 1955 separate return would be $3,000 and that of W for her separate return would be $2,000, each allowable in accordance with paragraph (a) of this section.

Example 2. H and W, husband and wife, make separate returns for 1966 following a

joint return for 1965. The capital gains and losses incurred by H and W in 1965, including those carried over by them to 1965, were as follows:

	H	W
Long-term capital gains	$8,000	$9,000
Long-term capital losses	(15,000)	(6,000)
Short-term capital gains	10,000	4,000
Short-term capital losses	(19,000)	(5,000)

Thus, in 1965 H and W had a net capital loss of $14,000 on their joint return. Of this amount, $4,000 was a long-term capital loss carryover, and $10,000 was a short-term capital loss carryover, determined in accordance paragraph (b) of this section. H's net long-term capital loss was $7,000 for 1965. This amount was offset on the joint return by W's net long-term capital gain of $3,000. Thus, H may carry over to his separate return for 1966, a long-term capital loss carryover of $4,000. H and W may carry over to their separate returns for 1966, as short-term capital loss carryovers, the amounts of their respective net short-term losses from 1965, $9,000 and $1,000.

[T.D. 6828, 30 FR 7806, June 17, 1965, as amended by T.D. 6867, 30 FR 15095, Dec. 7, 1965; T.D. 7301, 39 FR 968, Jan. 4, 1974; 39 FR 2758, Jan. 24, 1974; T.D. 7659, 44 FR 73019, Dec. 17, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

General Rules for Determining Capital Gains and Losses

§ 1.1221–1 Meaning of terms.

(a) The term *capital assets* includes all classes of property not specifically excluded by section 1221. In determining whether property is a *capital asset*, the period for which held is immaterial.

(b) Property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 167 and real property used in the trade or business of a taxpayer is excluded from the term *capital assets*. Gains and losses from the sale or exchange of such property are not treated as gains and losses from the sale or exchange of capital assets, except to the extent provided in section 1231. See §1.1231–1. Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term *capital assets* even though depreciation may have been allowed with respect to such property under section 23(l) of the Internal Revenue Code of 1939 before its amendment by section 121(c) of the Revenue Act of 1942 (56 Stat. 819). However, gain or loss upon the sale or exchange of land held by a taxpayer primarily for sale to customers in the ordinary course of his business, as in the case of a dealer in real estate, is not subject to the provisions of subchapter P (section 1201 and following), chapter 1 of the Code.

(c)(1) A copyright, a literary, musical, or artistic composition, and similar property are excluded from the term *capital assets* if held by a taxpayer whose personal efforts created such property, or if held by a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of a taxpayer whose personal efforts created such property. For purposes of this subparagraph, the phrase *similar property* includes for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law.

(2) In the case of sales and other dispositions occurring after July 25, 1969, a letter, a memorandum, or similar property is excluded from the term *capital asset* if held by (i) a taxpayer whose personal efforts created such property, (ii) a taxpayer for whom such property was prepared or produced, or (iii) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of a taxpayer described in subdivision (i) or (ii) of this subparagraph. In the case of a collection of letters, memorandums, or similar property held by a person who is a taxpayer described in subdivision (i), (ii), or (iii) of this subparagraph as to some of such letters, memorandums, or similar property but not as to others, this subparagraph shall apply only to those letters, memorandums, or similar property as

to which such person is a taxpayer described in such subdivision. For purposes of this subparagraph, the phrase *similar property* includes, for example, such property as a draft of a speech, a manuscript, a research paper, an oral recording of any type, a transcript of an oral recording, a transcript of an oral interview or of dictation, a personal or business diary, a log or journal, a corporate archive, including a corporate charter, office correspondence, a financial record, a drawing, a photograph, or a dispatch. A letter, memorandum, or property similar to a letter or memorandum, addressed to a taxpayer shall be considered as prepared or produced for him. This subparagraph does not apply to property, such as a corporate archive, office correspondence, or a financial record, sold or disposed of as part of a going business if such property has no significant value separate and apart from its relation to and use in such business; it also does not apply to any property to which subparagraph (1) of this paragraph applies (i.e., property to which section 1221(3) applied before its amendment by section 514(a) of the Tax Reform Act of 1969 (83 Stat. 643)).

(3) For purposes of this paragraph, in general, property is created in whole or in part by the personal efforts of a taxpayer if such taxpayer performs literary, theatrical, musical, artistic, or other creative or productive work which affirmatively contributes to the creation of the property, or if such taxpayer directs and guides others in the performance of such work. A taxpayer, such as corporate executive, who merely has administrative control of writers, actors, artists, or personnel and who does not substantially engage in the direction and guidance of such persons in the performance of their work, does not create property by his personal efforts. However, for purposes of subparagraph (2) of this paragraph, a letter or memorandum, or property similar to a letter or memorandum, which is prepared by personnel who are under the administrative control of a taxpayer, such as a corporate executive, shall be deemed to have been prepared or produced for him whether or not such letter, memorandum, or similar property is reviewed by him.

(4) For the application of section 1231 to the sale or exchange of property to which this paragraph applies, see § 1.1231–1. For the application of section 170 to the charitable contribution of property to which this paragraph applies, see section 170(e) and the regulations thereunder.

(d) Section 1221(4) excludes from the definition of *capital asset* accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of stock in trade or inventory or property held for sale to customers in the ordinary course of trade or business. Thus, if a taxpayer acquires a note receivable for services rendered, reports the fair market value of the note as income, and later sells the note for less than the amount previously reported, the loss is an ordinary loss. On the other hand, if the taxpayer later sells the note for more than the amount originally reported, the excess is treated as ordinary income.

(e) Obligations of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, are excluded from the term *capital assets*. An obligation may be issued on a discount basis even though the price paid exceeds the face amount. Thus, although the Second Liberty Bond Act (31 U.S.C. 754) provides that United States Treasury bills shall be issued on a discount basis, the issuing price paid for a particular bill may, by reason of competitive bidding, actually exceed the face amount of the bill. Since the obligations of the type described in this paragraph are excluded from the term *capital assets*, gains or losses from the sale or exchange of such obligations are not subject to the limitations provided in such subchapter P. It is, therefore, not necessary for a taxpayer (other than a life insurance company taxable under part I (section 801 and following), subchapter L, chapter 1 of the Code, as amended by the Life Insurance Company Tax Act of 1955 (70 Stat. 36), and, in the case of taxable years beginning

before January 1, 1955, subject to taxation only on interest, dividends, and rents) to segregate the original discount accrued and the gain or loss realized upon the sale or other disposition of any such obligation. See section 454(b) with respect to the original discount accrued. The provisions of this paragraph may be illustrated by the following examples:

Example 1. A (not a life insurance company) buys a $100,000, 90-day Treasury bill upon issuance for $99,998. As of the close of the forty-fifth day of the life of such bill, he sells it to B (not a life insurance company) for $99,999.50. The entire net gain to A of $1.50 may be taken into account as a single item of income, without allocating $1 to interest and $0.50 to gain. If B holds the bill until maturity his net gain of $0.50 may similarly be taken into account as a single item of income, without allocating $1 to interest and $0.50 to loss.

Example 2. The facts in this example are the same as in example (1) except that the selling price to B is $99,998.50. The net gain to A of $0.50 may be taken into account without allocating $1 to interest and $0.50 to loss, and, similarly, if B holds the bill until maturity his entire net gain of $1.50 may be taken into account as a single item of income without allocating $1 to interest and $0.50 to gain.

[T.D. 6500, 25 FR 12003, Nov. 26, 1960, as amended by T.D. 7369, 40 FR 29840, July 16, 1975]

§ 1.1221–2 Hedging transactions.

(a) *Treatment of hedging transactions*—(1) *In general.* This section governs the treatment of hedging transactions under section 1221(a)(7). Except as provided in paragraph (g)(2) of this section, the term capital asset does not include property that is part of a hedging transaction (as defined in paragraph (b) of this section).

(2) *Short sales and options.* This section also governs the character of gain or loss from a short sale or option that is part of a hedging transaction. Except as provided in paragraph (g)(2) of this section, gain or loss on a short sale or option that is part of a hedging transaction (as defined in paragraph (b) of this section) is ordinary income or loss.

(3) *Exclusivity.* If a transaction is not a hedging transaction as defined in paragraph (b) of this section, gain or loss from the transaction is not made ordinary on the grounds that property involved in the transaction is a surrogate for a noncapital asset, that the transaction serves as insurance against a business risk, that the transaction serves a hedging function, or that the transaction serves a similar function or purpose.

(4) *Coordination with section 988.* This section does not apply to determine the character of gain or loss realized on a section 988 transaction as defined in section 988(c)(1) or realized with respect to any qualified fund as defined in section 988(c)(1)(E)(iii).

(b) *Hedging transaction defined.* Section 1221(b)(2)(A) provides that a hedging transaction is any transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily—

(1) To manage risk of price changes or currency fluctuations with respect to ordinary property (as defined in paragraph (c)(2) of this section) that is held or to be held by the taxpayer;

(2) To manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or

(3) To manage such other risks as the Secretary may prescribe in regulations (see paragraph (d)(6) of this section).

(c) *General rules*—(1) *Normal course.* Solely for purposes of paragraph (b) of this section, if a transaction is entered into in furtherance of a taxpayer's trade or business, the transaction is entered into in the normal course of the taxpayer's trade or business. This rule includes managing risks relating to the expansion of an existing business or the acquisition of a new trade or business.

(2) *Ordinary property and obligations.* Property is ordinary property to a taxpayer only if a sale or exchange of the property by the taxpayer could not produce capital gain or loss under any circumstances. Thus, for example, property used in a trade or business within the meaning of section 1231(b) (determined without regard to the holding period specified in that section) is not ordinary property. An obligation is an ordinary obligation if performance or termination of the obligation by the taxpayer could not produce

capital gain or loss. For purposes of this paragraph (c)(2), the term termination has the same meaning as it does in section 1234A.

(3) *Hedging an aggregate risk.* The term hedging transaction includes a transaction that manages an aggregate risk of interest rate changes, price changes, and/or currency fluctuations only if all of the risk, or all but a de minimis amount of the risk, is with respect to ordinary property, ordinary obligations, or borrowings.

(4) *Managing risk*—(i) *In general.* Whether a transaction manages a taxpayer's risk is determined based on all of the facts and circumstances surrounding the taxpayer's business and the transaction. Whether a transaction manages a taxpayer's risk may be determined on a business unit by business unit basis (for example by treating particular groups of activities, including the assets and liabilities attributable to those activities, as separate business units), provided that the business unit is within a single entity or consolidated return group that adopts the single-entity approach. A taxpayer's hedging strategies and policies as reflected in the taxpayer's minutes or other records are evidence of whether particular transactions were entered into primarily to manage the taxpayer's risk.

(ii) *Limitation of risk management transactions to those specifically described.* Except as otherwise determined by published guidance or by private letter ruling, a transaction that is not treated as a hedging transaction under paragraph (d) does not manage risk. Moreover, a transaction undertaken for speculative purposes will not be treated as a hedging transaction.

(d) *Transactions that manage risk*—(1) *Risk reduction transactions*—(i) *In general.* A transaction that is entered into to reduce a taxpayer's risk, manages a taxpayer's risk.

(ii) *Micro and macro hedges*—(A) *In general.* A taxpayer generally has risk of a particular type only if it is at risk when all of its operations are considered. Nonetheless, a hedge of a particular asset or liability generally will be respected as reducing risk if it reduces the risk attributable to the asset or liability and if it is reasonably expected to reduce the overall risk of the taxpayer's operations. If a taxpayer hedges particular assets or liabilities, or groups of assets or liabilities, and the hedges are undertaken as part of a program that, as a whole, is reasonably expected to reduce the overall risk of the taxpayer's operations, the taxpayer generally does not have to demonstrate that each hedge that was entered into pursuant to the program reduces its overall risk.

(B) *Example.* The following example illustrates the rules stated in paragraph (d)(1)(ii)(A) of this section:

Example. Corporation X manages its business operations by treating particular groups of activities, including the assets and liabilities attributable to those assets, as separate business units. A separate set of books and records is maintained with respect to the activities, assets and liabilities of separate business unit *y*. As part of a risk management program that Corporation X reasonably expects to reduce the overall risks of its business operations, Corporation X enters into hedges to reduce the risks of separate business unit *y*. Corporation X may demonstrate that the hedges reduce risk by taking into account only the activities, assets and liabilities of business unit *y*.

(iii) *Written options.* A written option may reduce risk. For example, in appropriate circumstances, a written call option with respect to assets held by a taxpayer or a written put option with respect to assets to be acquired by a taxpayer may be a hedging transaction. See also paragraph (d)(3) of this section.

(iv) *Fixed-to-floating price hedges.* Under the principles of paragraph (d)(1)(ii)(A) of this section, a transaction that economically converts a price from a fixed price to a floating price may reduce risk. For example, a taxpayer with a fixed cost for its inventory may be at risk if the price at which the inventory can be sold varies with a particular factor. Thus, for such a taxpayer a transaction that converts its fixed price to a floating price may be a hedging transaction.

(2) *Interest rate conversions.* A transaction that economically converts an interest rate from a fixed rate to a floating rate or that converts an interest rate from a floating rate to a fixed rate manages risk.

(3) *Transactions that counteract hedging transactions*. If a transaction is entered into primarily to offset all or any part of the risk management effected by one or more hedging transactions, the transaction is a hedging transaction. For example, if a written option is used to reduce or eliminate the risk reduction obtained from another position such as a purchased option, then it may be a hedging transaction.

(4) *Recycling*. A taxpayer may enter into a hedging transaction by using a position that was a hedge of one asset or liability as a hedge of another asset or liability (recycling).

(5) *Transactions not entered into primarily to manage risk*—(i) *Rule*. Except as otherwise determined in published guidance or private letter ruling, the purchase or sale of a debt instrument, an equity security, or an annuity contract is not a hedging transaction even if the transaction limits or reduces the taxpayer's risk with respect to ordinary property, borrowings, or ordinary obligations. In addition, the Commissioner may determine in published guidance that other transactions are not hedging transactions.

(ii) *Examples*. The following examples illustrate the rule stated in paragraph (d)(5)(i) of this section:

Example 1. Taxpayer borrows money and agrees to pay a floating rate of interest. Taxpayer purchases debt instruments that bear a comparable floating rate. Although taxpayer's interest rate risk from the floating rate borrowing may be reduced by the purchase of the debt instruments, the acquisition of the debt instruments is not a hedging transaction, because the transaction is not entered into primarily to manage the taxpayer's risk.

Example 2. Taxpayer undertakes obligations to pay compensation in the future. The amount of the future compensation payments is adjusted as if amounts were invested in a specified mutual fund and were increased or decreased by the earnings, gains and losses that would result from such an investment. Taxpayer invests funds in the shares of the mutual fund. Although the investment in shares of the mutual fund reduces the taxpayer's risk of fluctuation in the amount of its obligation to employees, the investment was not made primarily to manage the taxpayer's risk. Accordingly, the transaction is not a hedging transaction.

Example 3. Taxpayer provides a nonqualified retirement plan for employees that is structured like a defined contribution plan. Based on a schedule that takes into account an employee's monthly salary and years of service with the taxpayer, the taxpayer makes monthly credits to an account for each employee. Each employee may designate that the account will be treated as if it were used to pay premiums on a variable annuity contract issued by the M insurance company with a value that reflects a specified investment option. M offers a number of investment options for its variable annuity contracts. Taxpayer invests funds in M company variable annuity contracts that parallel the investment options selected by the employees. The investment is not made primarily to manage the taxpayer's risk and is not a hedging transaction.

(6) *Hedges of other risks*. The Commissioner may, by published guidance, determine that hedging transactions include transactions entered into to manage risks other than interest rate or price changes, or currency fluctuations.

(7) *Miscellaneous provision*—(i) *Extent of risk management*. A taxpayer may hedge all or any portion of its risk for all or any part of the period during which it is exposed to the risk.

(ii) *Number of transactions*. The fact that a taxpayer frequently enters into and terminates positions (even if done on a daily or more frequent basis) is not relevant to whether these transactions are hedging transactions. Thus, for example, a taxpayer hedging the risk associated with an asset or liability may frequently establish and terminate positions that hedge that risk, depending on the extent the taxpayer wishes to be hedged. Similarly, if a taxpayer maintains its level of risk exposure by entering into and terminating a large number of transactions in a single day, its transactions may nonetheless qualify as hedging transactions.

(e) *Hedging by members of a consolidated group*—(1) *General rule: single-entity approach*. For purposes of this section, the risk of one member of a consolidated group is treated as the risk of the other members as if all of the members of the group were divisions of a single corporation. For example, if any member of a consolidated group hedges the risk of another member of the group by entering into a transaction with a third party, that transaction may potentially qualify as a hedging transaction. Conversely, intercompany transactions are not hedging

transactions because, when considered as transactions between divisions of a single corporation, they do not manage the risk of that single corporation.

(2) *Separate-entity election*. In lieu of the single-entity approach specified in paragraph (e)(1) of this section, a consolidated group may elect separate-entity treatment of its hedging transactions. If a group makes this separate-entity election, the following rules apply:

(i) *Risk of one member not risk of other members*. Notwithstanding paragraph (e)(1) of this section, the risk of one member is not treated as the risk of other members.

(ii) *Intercompany transactions*. An intercompany transaction is a hedging transaction (an intercompany hedging transaction) with respect to a member of a consolidated group if and only if it meets the following requirements—

(A) The position of the member in the intercompany transaction would qualify as a hedging transaction with respect to the member (taking into account paragraph (e)(2)(i) of this section) if the member had entered into the transaction with an unrelated party; and

(B) The position of the other member (the marking member) in the transaction is marked to market under the marking member's method of accounting.

(iii) *Treatment of intercompany hedging transactions*. An intercompany hedging transaction (that is, a transaction that meets the requirements of paragraphs (e)(2)(ii)(A) and (B) of this section) is subject to the following rules—

(A) The character and timing rules of § 1.1502–13 do not apply to the income, deduction, gain, or loss from the intercompany hedging transaction; and

(B) Except as provided in paragraph (g)(3) of this section, the character of the marking member's gain or loss from the transaction is ordinary.

(iv) *Making and revoking the election*. Unless the Commissioner otherwise prescribes, the election described in paragraph (e)(2) of this section must be made in a separate statement that provides, ''[INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER OF COMMON PARENT] HEREBY ELECTS THE APPLICATION OF § 1.1221–2(e)(2) (THE SEPARATE-ENTITY APPROACH).'' The statement must also indicate the date as of which the election is to be effective. The election must be filed by including the statement on or with the consolidated group's income tax return for the taxable year that includes the first date for which the election is to apply. The election applies to all transactions entered into on or after the date so indicated. The election may only be revoked with the consent of the Commissioner.

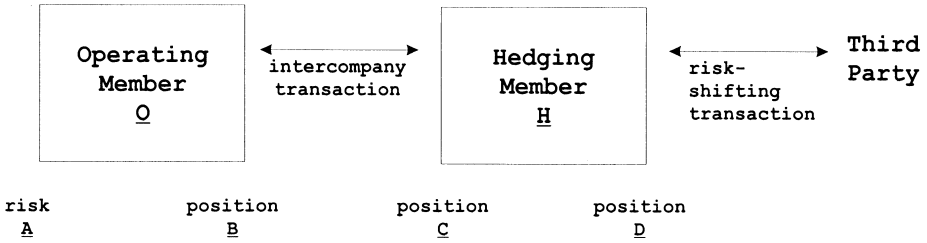
(3) *Definitions*. For definitions of consolidated group, divisions of a single corporation, group, intercompany transactions, and member, see section 1502 and the regulations thereunder.

(4) *Examples*. *General Facts*. In these examples, *O* and *H* are members of the same consolidated group. *O*'s business operations give rise to interest rate risk ''*A*,'' which *O* wishes to hedge. *O* enters into an intercompany transaction with *H* that transfers the risk to *H*. *O*'s position in the intercompany transaction is ''*B*,'' and *H*'s position in the transaction is ''*C*.'' *H* enters into position ''*D*'' with a third party to reduce the interest rate risk it has with respect to its position *C*. *D* would be a hedging transaction with respect to risk *A* if *O*'s risk *A* were *H*'s risk. The following examples illustrate this paragraph (e):

Example 1. Single-entity treatment. (i) *General rule*. Under paragraph (e)(1) of this section, *O*'s risk *A* is treated as *H*'s risk, and therefore *D* is a hedging transaction with respect to risk *A*. Thus, the character of *D* is determined under the rules of this section, and the income, deduction, gain, or loss from *D* must be accounted for under a method of accounting that satisfies § 1.446–4. The intercompany transaction *B-C* is not a hedging transaction and is taken into account under § 1.1502–13.

(ii) *Identification*. *D* must be identified as a hedging transaction under paragraph (f)(1) of this section, and *A* must be identified as the hedged item under paragraph (f)(2) of this section. Under paragraph (f)(5) of this section, the identification of *A* as the hedged item can be accomplished by identifying the positions in the intercompany transaction as hedges or hedged items, as appropriate. Thus, substantially contemporaneous with entering into *D*, *H* may identify *C* as the hedged item and *O* may identify *B* as a hedge and *A* as the hedged item.

Example 2. Separate-entity election; counterparty that does not mark to market. In addition to the *General Facts* stated above, assume that the group makes a separate-entity election under paragraph (e)(2) of this section. If *H* does not mark *C* to market under its method of accounting, then *B* is not a hedging transaction, and the *B-C* intercompany transaction is taken into account under the rules of section 1502. *D* is not a hedging transaction with respect to *A*, but *D* may be a hedging transaction with respect to *C* if *C* is ordinary property or an ordinary obligation and if the other requirements of paragraph (b) of this section are met. If *D* is not part of a hedging transaction, then *D* may be part of a straddle for purposes of section 1092.



Example 3. Separate-entity election; counterparty that marks to market. The facts are the same as in *Example 2* above, except that *H* marks *C* to market under its method of accounting. Also assume that *B* would be a hedging transaction with respect to risk *A* if *O* had entered into that transaction with an unrelated party. Thus, for *O*, the *B-C* transaction is an intercompany hedging transaction with respect to *O*'s risk *A*, the character and timing rules of §1.1502–13 do not apply to the *B-C* transaction, and *H*'s income, deduction, gain, or loss from *C* is ordinary. However, other attributes of the items from the *B-C* transaction are determined under §1.1502–13. *D* is a hedging transaction with respect to *C* if it meets the requirements of paragraph (b) of this section.

(f) *Identification and recordkeeping*—(1) *Same-day identification of hedging transactions.* Under section 1221(a)(7), a taxpayer that enters into a hedging transaction (including recycling an existing hedging transaction) must clearly identify it as a hedging transaction before the close of the day on which the taxpayer acquired, originated, or entered into the transaction (or recycled the existing hedging transaction).

(2) *Substantially contemporaneous identification of hedged item*—(i) *Content of the identification.* A taxpayer that enters into a hedging transaction must identify the item, items, or aggregate risk being hedged. Identification of an item being hedged generally involves identifying a transaction that creates risk, and the type of risk that the transaction creates. For example, if a taxpayer is hedging the price risk with respect to its June purchases of corn inventory, the transaction being hedged is the June purchase of corn and the risk is price movements in the market where the taxpayer buys its corn. For additional rules concerning the content of this identification, see paragraph (f)(3) of this section.

(ii) *Timing of the identification.* The identification required by this paragraph (f)(2) must be made substantially contemporaneously with entering into the hedging transaction. An identification is not substantially contemporaneous if it is made more than 35 days after entering into the hedging transaction.

(3) *Identification requirements for certain hedging transactions.* In the case of the hedging transactions described in this paragraph (f)(3), the identification under paragraph (f)(2) of this section must include the information specified.

(i) *Anticipatory asset hedges.* If the hedging transaction relates to the anticipated acquisition of assets by the taxpayer, the identification must include the expected date or dates of acquisition and the amounts expected to be acquired.

(ii) *Inventory hedges.* If the hedging transaction relates to the purchase or sale of inventory by the taxpayer, the identification is made by specifying the type or class of inventory to which

the transaction relates. If the hedging transaction relates to specific purchases or sales, the identification must also include the expected dates of the purchases or sales and the amounts to be purchased or sold.

(iii) *Hedges of debt of the taxpayer*—(A) *Existing debt*. If the hedging transaction relates to accruals or payments under an issue of existing debt of the taxpayer, the identification must specify the issue and, if the hedge is for less than the full issue price or the full term of the debt, the amount of the issue price and the term covered by the hedge.

(B) *Debt to be issued*. If the hedging transaction relates to the expected issuance of debt by the taxpayer or to accruals or payments under debt that is expected to be issued by the taxpayer, the identification must specify the following information: the expected date of issuance of the debt; the expected maturity or maturities; the total expected issue price; and the expected interest provisions. If the hedge is for less than the entire expected issue price of the debt or the full expected term of the debt, the identification must also include the amount or the term being hedged. The identification may indicate a range of dates, terms, and amounts, rather than specific dates, terms, or amounts. For example, a taxpayer might identify a transaction as hedging the yield on an anticipated issuance of fixed rate debt during the second half of its fiscal year, with the anticipated amount of the debt between $75 million and $125 million, and an anticipated term of approximately 20 to 30 years.

(iv) *Hedges of aggregate risk*—(A) *Required identification*. If a transaction hedges aggregate risk as described in paragraph (c)(3) of this section, the identification under paragraph (f)(2) of this section must include a description of the risk being hedged and of the hedging program under which the hedging transaction was entered. This requirement may be met by placing in the taxpayer's records a description of the hedging program and by establishing a system under which individual transactions can be identified as being entered into pursuant to the program.

(B) *Description of hedging program*. A description of a hedging program must include an identification of the type of risk being hedged, a description of the type of items giving rise to the risk being aggregated, and sufficient additional information to demonstrate that the program is designed to reduce aggregate risk of the type identified. If the program contains controls on speculation (for example, position limits), the description of the hedging program must also explain how the controls are established, communicated, and implemented.

(v) *Transactions that counteract hedging transactions*. If the hedging transaction is described in paragraph (d)(3) of this section, the description of the hedging transaction must include an identification of the risk management transaction that is being offset and the original underlying hedged item.

(4) *Manner of identification and records to be retained*—(i) *Inclusion of identification in tax records*. The identification required by this paragraph (f) must be made on, and retained as part of, the taxpayer's books and records.

(ii) *Presence of identification must be unambiguous*. The presence of an identification for purposes of this paragraph (f) must be unambiguous. The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer's books and records indicate that the identification is also being made for tax purposes. The taxpayer may indicate that individual hedging transactions, or a class or classes of hedging transactions, that are identified for financial accounting or regulatory purposes are also being identified as hedging transactions for purposes of this section.

(iii) *Manner of identification*. The taxpayer may separately and explicitly make each identification, or, so long as paragraph (f)(4)(ii) of this section is satisfied, the taxpayer may establish a system pursuant to which the identification is indicated by the type of transaction or by the manner in which the transaction is consummated or recorded. An identification under this system is made at the later of the time that the system is established or the time that the transaction satisfies the

terms of the system by being entered, or by being consummated or recorded, in the designated fashion.

(iv) *Principles of paragraph (f)(4)(iii) of this section illustrated.* Paragraphs (f)(4)(iv)(A) through (C) of this section illustrate the principles of paragraph (f)(4)(iii) of this section and assume that the other requirements of this paragraph (f) are satisfied.

(A) A taxpayer can make an identification by designating a hedging transaction for (or placing it in) an account that has been identified as containing only hedges of a specified item (or of specified items or specified aggregate risk).

(B) A taxpayer can make an identification by including and retaining in its books and records a statement that designates all future transactions in a specified derivative product as hedges of a specified item, items, or aggregate risk.

(C) A taxpayer can make an identification by designating a certain mark, a certain form, or a certain legend as meaning that a transaction is a hedge of a specified item (or of specified items or a specified aggregate risk). Identification can be made by placing the designated mark on a record of the transaction (for example, trading ticket, purchase order, or trade confirmation) or by using the designated form or a record that contains the designated legend.

(5) *Identification of hedges involving members of the same consolidated group*—(i) *General rule: single-entity approach.* A member of a consolidated group must satisfy the requirements of this paragraph (f) as if all of the members of the group were divisions of a single corporation. Thus, the member entering into the hedging transaction with a third party must identify the hedging transaction under paragraph (f)(1) of this section. Under paragraph (f)(2) of this section, that member must also identify the item, items, or aggregate risk that is being hedged, even if the item, items, or aggregate risk relates primarily or entirely to other members of the group. If the members of a group use intercompany transactions to transfer risk within the group, the requirements of paragraph (f)(2) of this section may be met by identifying the intercompany transactions, and the risks hedged by the intercompany transactions, as hedges or hedged items, as appropriate. Because identification of the intercompany transaction as a hedge serves solely to identify the hedged item, the identification is timely if made within the period required by paragraph (f)(2) of this section. For example, if a member transfers risk in an intercompany transaction, it may identify under the rules of this paragraph (f) both its position in that transaction and the item, items, or aggregate risk being hedged. The member that hedges the risk outside the group may identify under the rules of this paragraph (f) both its position with the third party and its position in the intercompany transaction. Paragraph (e)(4) *Example 1* of this section illustrates this identification.

(ii) *Rule for consolidated groups making the separate-entity election.* If a consolidated group makes the separate-entity election under paragraph (e)(2) of this section, each member of the group must satisfy the requirements of this paragraph (f) as though it were not a member of a consolidated group.

(6) *Consistency with section 1256(e)(2).* Any identification for purposes of section 1256(e)(2) is also an identification for purposes of paragraph (f)(1) of this section.

(g) *Effect of identification and nonidentification*—(1) *Transactions identified*—(i) *In general.* If a taxpayer identifies a transaction as a hedging transaction for purposes of paragraph (f)(1) of this section, the identification is binding with respect to gain, whether or not all of the requirements of paragraph (f) of this section are satisfied. Thus, gain from that transaction is ordinary income. If the transaction is not in fact a hedging transaction described in paragraph (b) of this section, however, paragraphs (a)(1) and (2) of this section do not apply and the character of loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or purpose. Thus, the taxpayer's identification of the transaction as a hedging transaction does

not itself make loss from the transaction ordinary.

(ii) *Inadvertent identification.* Notwithstanding paragraph (g)(1)(i) of this section, if the taxpayer identifies a transaction as a hedging transaction for purposes of paragraph (f) of this section, the character of the gain is determined as if the transaction had not been identified as a hedging transaction if—

(A) The transaction is not a hedging transaction (as defined in paragraph (b) of this section);

(B) The identification of the transaction as a hedging transaction was due to inadvertent error; and

(C) All of the taxpayer's transactions in all open years are being treated on either original or, if necessary, amended returns in a manner consistent with the principles of this section.

(2) *Transactions not identified*—(i) *In general.* Except as provided in paragraphs (g)(2)(ii) and (iii) of this section, the absence of an identification that satisfies the requirements of paragraph (f)(1) of this section is binding and establishes that a transaction is not a hedging transaction. Thus, subject to the exceptions, the rules of paragraphs (a)(1) and (2) of this section do not apply, and the character of gain or loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or purpose.

(ii) *Inadvertent error.* If a taxpayer does not make an identification that satisfies the requirements of paragraph (f) of this section, the taxpayer may treat gain or loss from the transaction as ordinary income or loss under paragraph (a)(1) or (2) of this section if—

(A) The transaction is a hedging transaction (as defined in paragraph (b) of this section);

(B) The failure to identify the transaction was due to inadvertent error; and

(C) All of the taxpayer's hedging transactions in all open years are being treated on either original or, if necessary, amended returns as provided in paragraphs (a)(1) and (2) of this section.

(iii) *Anti-abuse rule.* If a taxpayer does not make an identification that satisfies all the requirements of paragraph (f) of this section but the taxpayer has no reasonable grounds for treating the transaction as other than a hedging transaction, then gain from the transaction is ordinary. The reasonableness of the taxpayer's failure to identify a transaction is determined by taking into consideration not only the requirements of paragraph (b) of this section but also the taxpayer's treatment of the transaction for financial accounting or other purposes and the taxpayer's identification of similar transactions as hedging transactions.

(3) *Transactions by members of a consolidated group*—(i) *Single-entity approach.* If a consolidated group is under the general rule of paragraph (e)(1) of this section (the single-entity approach), the rules of this paragraph (g) apply only to transactions that are not intercompany transactions.

(ii) *Separate-entity election.* If a consolidated group has made the election under paragraph (e)(2) of this section, then, in addition to the rules of paragraphs (g)(1) and (2) of this section, the following rules apply:

(A) If an intercompany transaction is identified as a hedging transaction but does not meet the requirements of paragraphs (e)(2)(ii)(A) and (B) of this section, then, notwithstanding any contrary provision in § 1.1502–13, each party to the transaction is subject to the rules of paragraph (g)(1) of this section with respect to the transaction as though it had incorrectly identified its position in the transaction as a hedging transaction.

(B) If a transaction meets the requirements of paragraphs (e)(2)(ii) (A) and (B) of this section but the transaction is not identified as a hedging transaction, each party to the transaction is subject to the rules of paragraph (g)(2) of this section. (Because the transaction is an intercompany hedging transaction, the character and timing rules of § 1.1502–13 do not apply. See paragraph (e)(2)(iii)(A) of this section.)

(h) *Effective date.* The rules of this section apply to transactions entered into on or after March 20, 2002.

(i) [Reserved]. For further guidance, see § 1.1221–2T(i) through (j)(1).

(j) *Effective/applicability date.* Paragraph (e)(2)(iv) of this section applies to any original consolidated Federal income tax return due (without extensions) after June 14, 2007. For original consolidated Federal income tax returns due (without extensions) after May 30, 2006, and on or before June 14, 2007, see § 1.1221–2T as contained in 26 CFR part 1 in effect on April 1, 2007. For original consolidated Federal income tax returns due (without extensions) on or before May 30, 2006, see § 1.1221–2 as contained in 26 CFR part 1 in effect on April 1, 2006.

[T.D. 8985, 67 FR 12865, Mar. 20, 2002, as amended by T.D. 9264, 71 FR 30602, May 30, 2006; T.D. 9329, 72 FR 32804, June 14, 2007]

§ 1.1221–3 Time and manner for electing capital asset treatment for certain self-created musical works.

(a) *Description.* Section 1221(b)(3) allows an electing taxpayer to treat the sale or exchange of a musical composition or a copyright in a musical work created by the taxpayer's personal efforts (or having a basis determined by reference to the basis of such property in the hands of a taxpayer whose personal efforts created such property) as the sale or exchange of a capital asset. As a consequence, gain or loss from the sale or exchange is treated as capital gain or loss.

(b) *Time and manner for making the election.* An election described in this section is made separately for each musical composition (or copyright in a musical work) sold or exchanged during the taxable year. An election must be made on or before the due date (including extensions) of the income tax return for the taxable year of the sale or exchange. The election is made on Schedule D, ''Capital Gains and Losses,'' of the appropriate income tax form (for example, Form 1040, ''U.S. Individual Income Tax Return;'' Form 1065, ''U.S. Return of Partnership Income;'' Form 1120, ''U.S. Corporation Income Tax Return'') by treating the sale or exchange as the sale or exchange of a capital asset, in accordance with the form and its instructions.

(c) *Revocability of election.* The election described in this section is revocable with the consent of the Commissioner. To seek consent to revoke the election, a taxpayer must submit a request for a letter ruling under the applicable administrative procedures. Alternatively, an automatic extension of 6 months from the due date of the taxpayer's income tax return (excluding extensions) is granted to revoke the election, provided the taxpayer timely filed the taxpayer's income tax return and, within this 6-month extension period, the taxpayer files an amended income tax return that treats the sale or exchange as the sale or exchange of property that is not a capital asset.

(d) *Effective/applicability date.* This section applies to elections under section 1221(b)(3) in taxable years beginning after May 17, 2006.

[T.D. 9514, 76 FR 6554, Feb. 7, 2011]

§ 1.1222–1 Other terms relating to capital gains and losses.

(a) The phrase *short-term* applies to the category of gains and losses arising from the sale or exchange of capital assets held for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less; the phrase *long-term* to the category of gains and losses arising from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). The fact that some part of a loss from the sale or exchange of a capital asset may be finally disallowed because of the operation of section 1211 does not mean that such loss is not *taken into account in computing taxable income* within the meaning of that phrase as used in sections 1222(2) and 1222(4).

(b)(1) In the definition of *net short-term capital gain,* as provided in section 1222(5), the amounts brought forward to the taxable year under section 1212 (other than section 1212(b)(1)(B)) are short-term capital losses for such taxable year.

(2) In the definition of *net long-term capital gain,* as provided in section 1222(7), the amounts brought forward to the taxable year under section 1212(b)(1)(B) are long-term capital losses for such taxable year.

(c) Gains and losses from the sale or exchange of capital assets held for not more than 1 year (6 months for taxable

years beginning before 1977; 9 months for taxable years beginning in 1977) (described as short-term capital gains and short-term capital losses) shall be segregated from gains and losses arising from the sale or exchange of such assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) (described as long-term capital gains and long-term capital losses).

(d)(1) The term capital gain net income (net capital gain for taxable years beginning before January 1, 1977) means the excess of the gains from sales or exchanges of capital assets over the losses from sales or exchanges of capital assets, which losses include any amounts carried to the taxable year pursuant to section 1212(a) or section 1212(b).

(2) Notwithstanding subparagraph (1) of this paragraph, in the case of a taxpayer other than a corporation for taxable years beginning before January 1, 1964, the term *net capital gain* means the excess of (i) the sum of the gains from sales or exchanges of capital assets, plus the taxable income (computed without regard to gains and losses from sales or exchanges of capital assets and without regard to the deductions provided by section 151, relating to personal exemptions, or any deductions in lieu thereof) of the taxpayer or $1,000, whichever is smaller, over (ii) the losses from sales or exchanges of capital assets, which losses include amounts carried to the taxable year by such taxpayer under paragraph (a)(1) of § 1.1212–1. Thus, in the case of estates and trusts for taxable years beginning before January 1, 1964, taxable income for the purposes of this paragraph shall be computed without regard to gains and losses from sales or exchanges of capital assets and without regard to the deductions allowed by section 642(b) to estates and trusts in lieu of personal exemptions. The term *net capital gain* is not applicable in the case of a taxpayer other than a corporation for taxable years beginning after December 31, 1963, and before January 1, 1970. In the case of a taxpayer whose tax liability is computed under section 3 for taxable years beginning before January 1, 1964, the term *taxable income*, for purposes of this paragraph, shall be read as *adjusted gross income*.

(e) The term *net capital loss* means the excess of the losses from sales or exchanges of capital assets over the sum allowed under section 1211. However, in the case of a corporation, amounts which are short-term capital losses under § 1.1212–1(a) are excluded in determining such *net capital loss*.

(f) See section 165(g) and section 166(e), under which losses from worthless stocks, bonds, and other securities (if they constitute capital assets) are required to be treated as losses under subchapter P (section 1201 and following), chapter 1 of the Code, from the sale or exchange of capital assets, even though such securities are not actually sold or exchanged. See also section 1231 and § 1.1231–1 for the determination of whether or not gains and losses from the involuntary conversion of capital assets and from the sale, exchange, or involuntary conversion of certain property used in the trade or business shall be treated as gains and losses from the sale or exchange of capital assets. See also section 1236 and § 1.1236–1 for the determination of whether or not gains from the sale or exchange of securities by a dealer in securities shall be treated as capital gains, or whether losses from such sales or exchanges shall be treated as ordinary losses.

(g) In the case of nonresident alien individuals not engaged in trade or business within the United States, see section 871 and the regulations thereunder for the determination of the net amount of capital gains subject to tax.

(h) The term net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977) means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year.

[T.D. 6500, 25 FR 12004, Nov. 26, 1960, as amended by T.D. 6828, 30 FR 7808, June 17, 1965; T.D. 6867, 30 FR 15096, Dec. 7, 1965; T.D. 7301, 39 FR 971, Jan. 4, 1974; T.D. 7337, 39 FR 44978, Dec. 30, 1974; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1223–1 Determination of period for which capital assets are held.

(a) The holding period of property received in an exchange by a taxpayer includes the period for which the property which he exchanged was held by him, if the property received has the same basis in whole or in part for determining gain or loss in the hands of the taxpayer as the property exchanged. However, this rule shall apply, in the case of exchanges after March 1, 1954, only if the property exchanged was at the time of the exchange a capital asset in the hands of the taxpayer or property used in his trade or business as defined in section 1231(b). For the purposes of this paragraph, the term *exchange* includes the following transactions:

(1) An involuntary conversion described in section 1033, and

(2) A distribution to which section 355 (or so much of section 356 as relates to section 355) applies.

Thus, if property acquired as the result of a compulsory or involuntary conversion of other property of the taxpayer has under section 1033(c) the same basis in whole or in part in the hands of the taxpayer as the property so converted, its acquisition is treated as an exchange and the holding period of the newly acquired property shall include the period during which the converted property was held by the taxpayer. Thus, also, where stock of a controlled corporation is received by a taxpayer pursuant to a distribution to which section 355 (or so much of section 356 as relates to section 355) applies, the distribution is treated as an exchange and the period for which the taxpayer has held the stock of the controlled corporation shall include the period for which he held the stock of the distributing corporation with respect to which such distribution was made.

(b) The holding period of property in the hands of a taxpayer shall include the period during which the property was held by any other person, if such property has the same basis in whole or in part in the hands of the taxpayer for determining gain or loss from a sale or exchange as it would have in the hands of such other person. For example, the period for which property acquired by gift after December 31, 1920, was held by the donor must be included in determining the period for which the property was held by the taxpayer if, under the provisions of section 1015, such property has, for the purpose of determining gain or loss from the sale or exchange, the same basis in the hands of the taxpayer as it would have in the hands of the donor. Similarly, the period for which property acquired from a decedent who died in 2010 was held by the decedent must be included in determining the period during which the property was held by the recipient, if the recipient's basis in the property is determined under section 1022.

(c) In determining the period for which the taxpayer has held stock or securities received upon a distribution where no gain was recognized to the distributee under section 1081(c) (or under section 112(g) of the Revenue Act of 1928 (45 Stat. 818) or the Revenue Act of 1932 (47 Stat. 197)), there shall be included the period for which he held the stock or securities in the distributing corporation before the receipt of the stock or securities on such distribution.

(d) If the acquisition of stock or securities resulted in the nondeductibility (under section 1091, relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, the holding period of the newly acquired securities shall include the period for which the taxpayer held the securities with respect to which the loss was not allowable.

(e) The period for which the taxpayer has held stock, or stock subscription rights, received on a distribution shall be determined as though the stock dividend, or stock right, as the case may be, were the stock in respect of which the dividend was issued if the basis for determining gain or loss upon the sale or other disposition of such stock dividend or stock right is determined under section 307. If the basis of stock received by a taxpayer pursuant to a spin-off is determined under so much of section 1052(c) as refers to section 113(a)(23) of the Internal Revenue Code of 1939, and such stock is sold or otherwise disposed of in a taxable year which is subject to the Internal Revenue Code of 1954, the period for which

the taxpayer has held the stock received in such spin-off shall include the period for which he held the stock of the distributing corporation with respect to which such distribution was made.

(f) The period for which the taxpayer has held stock or securities issued to him by a corporation pursuant to the exercise by him of rights to acquire such stock or securities from the corporation will, in every case and whether or not the receipt of taxable gain was recognized in connection with the distribution of the rights, begin with and include the day upon which the rights to acquire such stock or securities were exercised. A taxpayer will be deemed to have exercised rights received from a corporation to acquire stock or securities therein where there is an expression of assent to the terms of such rights made by the taxpayer in the manner requested or authorized by the corporation.

(g) The period for which the taxpayer has held a residence, the acquisition of which resulted under the provisions of section 1034 in the nonrecognition of any part of the gain realized on the sale or exchange of another residence, shall include the period for which such other residence had been held as of the date of such sale or exchange. For purposes of this paragraph, the term *sale or exchange* includes an involuntary conversion occurring after December 31, 1950, and before January 1, 1954.

(h) If a taxpayer accepts delivery of a commodity in satisfaction of a commodity futures contract, the holding period of the commodity shall include the period for which the taxpayer held the commodity futures contract, if such futures contract was a capital asset in his hands.

(i) If shares of stock in a corporation are sold from lots purchased at different dates or at different prices and the identity of the lots cannot be determined, the rules prescribed by the regulations under section 1012 for determining the cost or other basis of such stocks so sold or transferred shall also apply for the purpose of determining the holding period of such stock.

(j) In the case of a person acquiring property, or to whom property passed, from a decedent (within the meaning of section 1014(b)) dying after December 31, 1970, such person shall be considered to have held the property for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) if the property:

(1) Has a basis in the hands of such person which is determined in whole or in part under section 1014, and

(2) Is sold or otherwise disposed of by such person within 6 months after the decedent's death.

The provisions of this paragraph apply to sales of such property included in the decedent's gross estate for the purposes of the estate tax by the executor or administrator of the estate and to sales of such property by other persons who have acquired property from the decedent. The provisions of this paragraph may also be applicable to cases involving joint tenancies, community property, and properties transferred in contemplation of death. Thus, if a surviving joint tenant, who acquired property by right of survivorship, sells or otherwise disposes of such property within 6 months after the date of the decedent's death, and the basis of the property in his hands is determined in whole or in part under section 1014, the property shall be considered to have been held by the surviving joint tenant for more than 6 months. Similarly, a surviving spouse's share of community property shall be considered to have been held by her for more than 6 months if it is sold or otherwise disposed of within 6 months after the date of the decedent's death, regardless of when the property was actually acquired by the marital community. For the purposes of this paragraph, it is immaterial that the sale or other disposition produces gain or loss. If property is considered to have been held for more than 6 months by reason of this paragraph, it also is considered to have been held for that period for purposes of section 1231 (if that section is otherwise applicable).

(k) Any reference in section 1223 or this section to another provision of the Internal Revenue Code of 1954 is, where applicable, to be deemed a reference to the corresponding provision of the Internal Revenue Code of 1939, or prior

internal revenue laws. The provisions of prior internal revenue laws here intended are the sections referred to in the sections of the Internal Revenue Code of 1939 which correspond to the sections of the Internal Revenue Code of 1954 referred to in section 1223. Thus, the sections corresponding to section 1081(c) are section 371(c) of the Revenue Act of 1938 (52 Stat. 553) and section 371(c) of the Internal Revenue Code of 1939. The sections corresponding to section 1091 are section 118 of each of the following: The Revenue Acts of 1928 (45 Stat. 826), 1932 (47 Stat. 208), 1934 (48 Stat. 715), 1936 (49 Stat. 1692), 1938 (52 Stat. 503), and the Internal Revenue Code of 1939.

(l) *Effective/applicability date.* This section applies January 19, 2017. For rules before January 19, 2017, see §1.1223–1 as contained in 26 CFR part 1 revised as of April 1, 2016.

[T.D. 6500, 25 FR 12005, Nov. 26, 1960, as amended by T.D. 7238, 37 FR 28717, Dec. 29, 1972; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 9811, 82 FR 6241, Jan. 19, 2017; T.D. 9849, 84 FR 9237, Mar. 14, 2019]

§1.1223–3 Rules relating to the holding periods of partnership interests.

(a) *In general.* A partner shall not have a divided holding period in an interest in a partnership unless—

(1) The partner acquired portions of an interest at different times; or

(2) The partner acquired portions of the partnership interest in exchange for property transferred at the same time but resulting in different holding periods (*e.g.*, section 1223).

(b) *Accounting for holding periods of an interest in a partnership*—(1) *General rule.* The portion of a partnership interest to which a holding period relates shall be determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates, and the denominator of which is the fair market value of the entire partnership interest (determined immediately after the transaction).

(2) *Special rule.* For purposes of applying paragraph (b)(1) of this section to determine the holding period of a partnership interest (or portion thereof) that is sold or exchanged (or with respect to which gain or loss is recognized upon a distribution under section 731), if a partner makes one or more contributions of cash to the partnership and receives one or more distributions of cash from the partnership during the one-year period ending on the date of the sale or exchange (or distribution with respect to which gain or loss is recognized under section 731), the partner may reduce the cash contributions made during the year by cash distributions received on a last-in-first-out basis, treating all cash distributions as if they were received immediately before the sale or exchange (or at the time of the distribution with respect to which gain or loss is recognized under section 731).

(3) *Deemed contributions and distributions.* For purposes of paragraphs (b)(1) and (2) of this section, deemed contributions of cash under section 752(a) and deemed distributions of cash under section 752(b) shall be disregarded to the same extent that such amounts are disregarded under §1.704–1(b)(2)(iv)(c).

(4) *Adjustment with respect to contributed section 751 assets.* For purposes of applying paragraph (b)(1) of this section to determine the holding period of a partnership interest (or portion thereof) that is sold or exchanged, if a partner receives a portion of the partnership interest in exchange for property described in section 751(c) or (d) (section 751 assets) within the one-year period ending on the date of the sale or exchange of all or a portion of the partner's interest in the partnership, and the partner recognizes ordinary income or loss on account of such a section 751 asset in a fully taxable transaction (either as a result of the sale of all or part of the partner's interest in the partnership or the sale by the partnership of the section 751 asset), the contribution of the section 751 asset during the one-year period shall be disregarded. However, if, in the absence of this paragraph, a partner would not be treated as having held any portion of the interest for more than one year (*e.g.*, because the partner's only contributions to the partnership are contributions of section 751 assets or section 751 assets and cash within the prior one-year period), this adjustment is not available.

(5) *Divided holding period if partnership interest comprises in whole or in part one or more profits interests*—(i) *In general*. If a partnership interest is comprised in whole or in part of one or more profits interests (as defined in paragraph (b)(5)(ii) of this section), then, for purposes of applying paragraph (b)(1) of this section, the portion of the holding period to which a profits interest relates is determined based on the fair market value of the profits interest upon the disposition of all, or part, of the interest (and not at the time that the profits interest is acquired). Paragraph (b)(1) of this section continues to apply to the extent that a partner acquires portions of a partnership interest that are not comprised of a profits interest and the value of the profits interest is not included for purposes of determining the value of the entire partnership interest under paragraph (b)(1).

(ii) *Definition of capital interest and profits interest*. For purposes of this paragraph (b)(5), a profits interest is a partnership interest other than a capital interest. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value at the time the interest was received and then the proceeds were distributed in a complete liquidation of the partnership. A profits interest, for purposes of this paragraph (b)(5), is received in connection with the performance of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, and the receipt of the interest is not treated as a taxable event for the partner or the partnership under applicable Federal income tax guidance.

(6) *Exception*. The Commissioner may prescribe by guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) a rule disregarding certain cash contributions (including contributions of a de minimis amount of cash) in applying paragraph (b)(1) of this section to determine the holding period of a partnership interest (or portion thereof) that is sold or exchanged.

(c) *Sale or exchange of all or a portion of an interest in a partnership*—(1) *Sale or exchange of entire interest in a partnership*. If a partner sells or exchanges the partner's entire interest in a partnership, any capital gain or loss recognized shall be divided between long-term and short-term capital gain or loss in the same proportions as the holding period of the interest in the partnership is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less.

(2) *Sale or exchange of a portion of an interest in a partnership*—(i) *Certain publicly traded partnerships*. A selling partner in a publicly traded partnership (as defined under section 7704(b)) may use the actual holding period of the portion of a partnership interest transferred if—

(A) The ownership interest is divided into identifiable units with ascertainable holding periods;

(B) The selling partner can identify the portion of the partnership interest transferred; and

(C) The selling partner elects to use the identification method for all sales or exchanges of interests in the partnership after September 21, 2000. The selling partner makes the election referred to in this paragraph (c)(2)(i)(C) by using the actual holding period of the portion of the partner's interest in the partnership first transferred after September 21, 2000 in reporting the transaction for Federal income tax purposes.

(ii) *Other partnerships*. If a partner has a divided holding period in a partnership interest, and paragraph (c)(2)(i) of this section does not apply, then the holding period of the transferred interest shall be divided between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the transferor partner would realize if the entire interest in the partnership were transferred in a fully taxable transaction immediately before the actual transfer.

(d) *Distributions*—(1) *In general*. Except as provided in paragraph (b)(2) of this section, a partner's holding period in a partnership interest is not affected by distributions from the partnership.

(2) *Character of capital gain or loss recognized as a result of a distribution from a partnership*. If a partner is required to

recognize capital gain or loss as a result of a distribution from a partnership, then the capital gain or loss recognized shall be divided between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the distributee partner would realize if such partner's entire interest in the partnership were transferred in a fully taxable transaction immediately before the distribution.

(e) *Section 751(c) assets.* For purposes of this section, properties and potential gain treated as unrealized receivables under section 751(c) shall be treated as separate assets that are not capital assets as defined in section 1221 or property described in section 1231.

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

(1) *Example 1.* Division of holding period—contribution of money and a capital asset.

(i) *A* contributes $5,000 of cash and a nondepreciable capital asset *A* has held for two years to a partnership (*PRS*) for a 50 percent interest in *PRS*. *A*'s basis in the capital asset is $5,000, and the fair market value of the asset is $10,000. After the exchange, *A*'s basis in *A*'s interest in *PRS* is $10,000, and the fair market value of the interest is $15,000. *A* received one-third of the interest in *PRS* for a cash payment of $5,000 ($5,000/$15,000). Therefore, *A*'s holding period in one-third of the interest received (attributable to the contribution of money to the partnership) begins on the day after the contribution. *A* received two-thirds of the interest in *PRS* in exchange for the capital asset ($10,000/$15,000). Accordingly, pursuant to section 1223(1), *A* has a two-year holding period in two-thirds of the interest received in *PRS*.

(ii) Six months later, when *A*'s basis in *PRS* is $12,000 (due to a $2,000 allocation of partnership income to *A*), *A* sells the interest in *PRS* for $17,000. Assuming *PRS* holds no inventory or unrealized receivables (as defined under section 751(c)) and no collectibles or section 1250 property, *A* will realize $5,000 of capital gain. As determined above, one-third of *A*'s interest in *PRS* has a holding period of one year or less, and two-thirds of *A*'s interest in *PRS* has a holding period equal to two years and six months. Therefore, one-third of the capital gain will be short-term capital gain, and two-thirds of the capital gain will be long-term capital gain.

(2) *Example 2.* Division of holding period—contribution of section 751 asset and a capital asset.

A contributes inventory with a basis of $2,000 and a fair market value of $6,000 and a capital asset which *A* has held for more than one year with a basis of $4,000 and a fair market value of $6,000, and *B* contributes cash of $12,000 to form a partnership (*AB*). As a result of the contribution, one-half of *A*'s interest in *AB* is treated as having been held for more than one year under section 1223(1). Six months later, *A* transfers one-half of *A*'s interest in *AB* to *C* for $6,000, realizing a gain of $3,000. If *AB* 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 $4,000 of ordinary income on account of the inventory. Accordingly, *A* will recognize $2,000 of ordinary income and $1,000 of capital gain ($3,000–$2,000) on account of the transfer to *C*. Because *A* recognizes ordinary income on account of the inventory that was contributed to *AB* within the one year period ending on the date of the sale, the inventory will be disregarded in determining the holding period of *A*'s interest in *AB*. All of the capital gain will be long-term.

(3) *Example 3.* Netting of cash contributions and distributions.

(i) On January 1, 2000, *A* holds a 50 percent interest in the capital and profits of a partnership (*PS*). The value of *A*'s *PS* interest is $900, and *A*'s holding period in the entire interest is long-term. On January 2, 2000, when the value of *A*'s *PS* interest is still $900, *A* contributes $100 to *PS*. On June 1, 2000, *A* receives a distribution of $40 cash from the partnership. On September 1, 2000, when the value of *A*'s interest in *PS* is $1,350, *A* contributes an additional $230 cash to *PS*, and on October 1, 2000, *A* receives another $40 cash distribution from *PS*. *A* sells *A*'s entire partnership interest on November 1, 2000, for $1,600. *A*'s adjusted basis in the *PS* interest at the time of the sale is $1,000.

(ii) For purposes of netting cash contributions and distributions in determining the holding period of *A*'s interest in *PS*, *A* is treated as having received a distribution of $80 on November 1, 2000. Applying that distribution on a last-in-first-out basis to reduce prior contributions during the year, the contribution made on September 1, 2000, is reduced to $150 ($230–$80). The holding period then is determined as follows: Immediately after the contribution of $100 on January 2, 2000, *A*'s holding period in *A*'s *PS* interest is 90 percent long-term ($900/($900 + $100)) and 10 percent short-term ($100/($900 + $100)). The contribution of $150 on September 1, 2000, causes 10 percent of *A*'s partnership interest ($150/($1,350 + $150)) to have a short-term holding period. Accordingly, immediately after the contribution on September 1, 2000, *A*'s holding period in *A*'s *PS* interest is 81 percent long-term (.90 × .90) and 19 percent short-term ((.10 × .90) + .10). Accordingly, $486 ($600 × .81) of the gain from *A*'s sale of the *PS* interest is long-term capital gain, and $114 ($600 × .19) is short-term capital gain.

(4) *Example 4*. Division of holding period when capital account is increased by contribution.

A, *B*, *C*, and *D* are equal partners in a partnership (*PRS*), and the fair market value of a 25 percent interest in *PRS* is $100. *A*, *B*, *C*, and *D* each contribute an additional $100 to partnership capital, thereby increasing the fair market value of each partner's interest to $200. As a result of the contribution, each partner has a new holding period in the portion of the partner's interest in *PRS* that is attributable to the contribution. That portion equals 50 percent ($100/$200) of each partner's interest in *PRS*.

(5) *Example 5*. Sale or exchange of a portion of an interest in a partnership.

(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 (capital asset 1) with a fair market value of $5,000 and a basis of $2,000; *B* contributes $7,000 in cash and a capital asset (capital asset 2) 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 one-half of *A*'s interest in *PRS* to *T* for $7,000 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 1	2,000	5,000
Capital Asset 2	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.

(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. One-half of that amount ($1,000) is attributable to the portion of *A*'s interest in *PRS* transferred to *T*. Accordingly, *A* will recognize $1,000 oridnary income and $2,500 ($3,500–$1,000) of capital gain on account of the transfer to *T* of one-half of *A*'s interest in *PRS*. Fifty percent ($1,250) of that gain is long-term capital gain and 50 percent ($1,250) is short-term capital gain.

(6) *Example 6*. Sale of units of interests in a partnership.

A publicly traded partnership (*PRS*) has ownership interests that are segregated into identifiable units of interest. *A* owns 10 limited partnership units in *PRS* for which *A* paid $10,000 on January 1, 1999. On August 1, 2000, *A* purchases five additional units for $10,000. At the time of purchase, the fair market value of each unit has increased to $2,000. *A*'s holding period for one-third ($10,000/$30,000) of the interest in *PRS* begins on the day after the purchase of the five additional units. Less than one year later, *A* sells five units of ownership in *PRS* for $11,000. At the

time, *A*'s basis in the 15 units of *PRS* is $20,000, and *A*'s capital gain on the sale of 5 units is $4,333 (amount realized of $11,000 – one-third of the adjusted basis or $6,667). For purposes of determining the holding period, *A* can designate the specific units of *PRS* sold. If *A* properly identifies the five units sold as five of the ten units for which *A* has a long-term holding period and elects to use the identification method for all subsequent sales or exchanges of interests in the partnership by using the actual holding period in reporting the transaction on *A*'s Federal income tax return, the capital gain realized will be long-term capital gain.

(7) *Example 7*. Disproportionate distribution.

In 1997, *A* and *B* each contribute cash of $50,000 to form and become equal partners in a partnership (*PRS*). More than one year later, *A* receives a distribution worth $22,000 from *PRS*, which reduces *A*'s interest in *PRS* to 36 percent. After the distribution, *B* owns 64 percent of *PRS*. The holding periods of *A* and *B* in their interests in *PRS* are not affected by the distribution.

(8) *Example 8*. Gain or loss as a result of a distribution.

(i) On January 1, 1996, *A* contributes property with a basis of $10 and a fair market value of $10,000 in exchange for an interest in a partnership (*ABC*). On September 30, 2000, when *A*'s interest in *ABC* is worth $12,000 (and the basis of *A*'s partnership interest is still $10), *A* contributes $12,000 cash in exchange for an additional interest in *ABC*. *A* is allocated a loss equal to $10,000 by *ABC* for the taxable year ending December 31, 2000, thereby reducing the basis of *A*'s partnership interest to $2,010. On February 1, 2001, *ABC* makes a cash distribution to *A* of $10,000. *ABC* holds no inventory or unrealized receivables. (assume that *A* is allocated no gain or loss for the taxable year ending December 31, 2001, so that the basis of *A*'s partnership interest does not increase or decrease as a result of such allocations.)

(ii) The netting rule contained in paragraph (b)(2) of this section provides that, in determining the holding period of *A*'s interest in *ABC*, the cash contribution made on September 30, 2000, must be reduced by the distribution made on February 1, 2001. Accordingly, for purposes of determining the holding period of *A*'s interest in *ABC*, *A* is treated as having made a cash contribution of $2,000 ($12,000–$10,000) to *ABC* on September 30, 2000. *A*'s holding period in one-seventh of *A*'s interest in *ABC* ($2,000 cash contributed over the $14,000 value of the entire interest (determined as if only $2,000 were contributed rather than $12,000)) begins on the day after the cash contribution. *A* recognizes $7,990 of capital gain as a result of the distribution. See section 731(a)(1). One-seventh of the capital gain recognized as a result of the distribution is short-term capital gain, and six-sevenths of the capital gain is long-term capital gain. After the distribution, *A*'s basis in the interest in *PRS* is $0, and the holding period for the interest in *PRS* continues to be divided in the same proportions as before the distribution.

(9) *Example 9*. On June 1, 2020, GP contributes $10,000 to PRS for a partnership interest in PRS. On June 30, 2023, GP receives a 20% interest in the profits of PRS that is an Applicable Partnership Interest (API) as defined in § 1.1061–1(a). On June 30, 2025, GP sells its interest in PRS for $30,000. At the time of GP's sale of its interest, the API has a fair market value of $15,000. GP has a divided holding period in its interest in PRS; 50% of the partnership interest has a holding period beginning on June 1, 2020, and 50% has a holding period that begins on June 30, 2023.

(10) *Example 10*. Assume the same facts as in paragraph (f)(9) of this section (*Example 9*), except that on June 30, 2024, GP contributes an additional $5,000 cash to GP prior to GP's sale of its interest in 2025. Immediately after the contribution of the $5,000 on June 30, 2024, GP's interest in PRS has a value of $15,000, not taking into account the value of GP's profits interest in PRS. GP calculates its holding period in the portions not comprised by the profits interest and two-thirds of its holding period runs from June 30, 2020, and one-third runs from June 30, 2024. On June 30, 2025, GP sells its interest for $30,000 and the API has a fair market value of $15,000. Accordingly, on the date of disposition, one-third of GP's interest has a five year holding

period from its interest received in 2020 for its $10,000 contribution, one-half of GP's interest has a two year holding period from the profits interest issued on June 30, 2023, and one-sixth of GP's interest has a one year holding period from the contribution of the $5,000.

(g) *Applicability dates.* This section applies to transfers of partnership interests and distributions of property from a partnership that occur on or after September 21, 2000. Paragraphs (b)(5) and (f)(9) and (10) of this section apply to taxable years beginning on or after January 19, 2021.

[T.D. 8902, 65 FR 57099, Sept. 21, 2000, as amended by T.D. 9945, 86 FR 5494, Jan. 19, 2021]

SPECIAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

§ 1.1231–1 Gains and losses from the sale or exchange of certain property used in the trade or business.

(a) *In general.* Section 1231 provides that, subject to the provisions of paragraph (e) of this section, a taxpayer's gains and losses from the disposition (including involuntary conversion) of assets described in that section as *property used in the trade or business* and from the involuntary conversion of capital assets held for more than 6 months shall be treated as long-term capital gains and losses if the total gains exceed the total losses. If the total gains do not exceed the total losses, all such gains and losses are treated as ordinary gains and losses. Therefore, if the taxpayer has no gains subject to section 1231, a recognized loss from the condemnation (or from a sale or exchange under threat of condemnation) of even a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) is an ordinary loss. Capital assets subject to section 1231 treatment include only capital assets involuntarily converted. The noncapital assets subject to section 1231 treatment are (1) depreciable business property and business real property held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) other than stock in trade and certain copyrights and artistic property and, in the case of sales and other dispositions occurring after July 25, 1969, other than a letter, memorandum, or property similar to a letter or memorandum; (2) timber, coal, and iron ore which do not otherwise meet the requirements of section 1231 but with respect to which section 631 applies; and (3) certain livestock and unharvested crops. See paragraph (c) of this section.

(b) *Treatment of gains and losses.* For the purpose of applying section 1231, a taxpayer must aggregate his recognized gains and losses from:

(1) The sale, exchange, or involuntary conversion of property used in the trade or business (as defined in section 1231(b)), and

(2) The involuntary conversion (but not sale or exchange) of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

If the gains to which section 1231 applies exceed the losses to which the section applies, the gains and losses are treated as long-term capital gains and losses and are subject to the provisions of parts I and II (section 1201 and following), subchapter P, chapter 1 of the Code, relating to capital gains and losses. If the gains to which section 1231 applies do not exceed the losses to which the section applies, the gains and losses are treated as ordinary gains and losses. Therefore, in the latter case, a loss from the involuntary conversion of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) is treated as an ordinary loss and is not subject to the limitation on capital losses in section 1211. The phrase *involuntary conversion* is defined in paragraph (e) of this section.

(c) *Transactions to which section applies.* Section 1231 applies to recognized gains and losses from the following:

(1) The sale, exchange, or involuntary conversion of property held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and used in the taxpayer's trade or business, which is either real property or is of a character subject to the allowance for

depreciation under section 167 (even though fully depreciated), and which is not:

(i) Property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of business;

(ii) A copyright, a literary, musical, or artistic composition, or similar property, or (in the case of sales and other dispositions occurring after July 25, 1969) a letter, memorandum, or property similar to a letter or memorandum, held by a taxpayer described in section 1221(3); or

(iii) Livestock held for draft, breeding, dairy, or sporting purposes, except to the extent included under paragraph (4) of this paragraph, or poultry.

(2) The involuntary conversion of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(3) The cutting or disposal of timber, or the disposal of coal or iron ore, to the extent considered arising from a sale or exchange by reason of the provisions of section 631 and the regulations thereunder.

(4) The sale, exchange, or involuntary conversion of livestock if the requirements of § 1.1231–2 are met.

(5) The sale, exchange, or involuntary conversion of unharvested crops on land which is (i) used in the taxpayer's trade or business and held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), and (ii) sold or exchanged at the same time and to the same person. See paragraph (f) of this section.

For purposes of section 1231, the phrase *property used in the trade or business* means property described in this paragraph (other than property described in subparagraph (2) of this paragraph). Notwithstanding any of the provisions of this paragraph, section 1231(a) does not apply to gains and losses under the circumstances described in paragraph (e) (2) or (3) of this section.

(d) *Extent to which gains and losses are taken into account.* All gains and losses to which section 1231 applies must be taken into account in determining whether and to what extent the gains exceed the losses. For the purpose of this computation, the provisions of section 1211 limiting the deduction of capital losses do not apply, and no losses are excluded by that section. With that exception, gains are included in the computations under section 1231 only to the extent that they are taken into account in computing gross income, and losses are included only to the extent that they are taken into account in computing taxable income. The following are examples of gains and losses not included in the computations under section 1231:

(1) Losses of a personal nature which are not deductible by reason of section 165 (c) or (d), such as losses from the sale of property held for personal use;

(2) Losses which are not deductible under section 267 (relating to losses with respect to transactions between related taxpayers) or section 1091 (relating to losses from wash sales);

(3) Gain on the sale of property (to which section 1231 applies) reported for any taxable year on the installment method under section 453, except to the extent the gain is to be reported under section 453 for the taxable year; and

(4) Gains and losses which are not recognized under section 1002, such as those to which sections 1031 through 1036, relating to common nontaxable exchanges, apply.

(e) *Involuntary conversion*—(1) *General rule.* For purposes of section 1231, the terms *compulsory or involuntary conversion* and *involuntary conversion* of property mean the conversion of proeprty into money or other property as a result of complete or partial destruction, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof. Losses upon the complete or partial destruction, theft, seizure, requisition, or condemnation of property are treated as losses upon an involuntary conversion whether or not there is a conversion of the property into other property or money and whether or not the property is uninsured, partially insured, or totally insured. For example, if a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable

years beginning in 1977), with an adjusted basis of $400, but not held for the production of income, is stolen, and the loss which is sustained in the taxable year 1956 is not compensated for by insurance or otherwise, section 1231 applies to the $400 loss. For certain exceptions to this subparagraph, see subparagraphs (2) and (3) of this paragraph.

(2) *Certain uninsured losses.* Notwithstanding the provisions of subparagraph (1) of this paragraph, losses sustained during a taxable year beginning after December 31, 1957, and before January 1, 1970, with respect to both property used in the trade or business and any capital asset held for more than 6 months and held for the production of income, which losses arise from fire, storm, shipwreck, or other casualty, or from theft, and which are not compensated for by insurance in any amount, are not losses to which section 1231(a) applies. Such losses shall not be taken into account in applying the provisions of this section.

(3) *Exclusion of gains and losses from certain involuntary conversions.* Notwithstanding the provisions of subparagraph (1) of this paragraph, if for any taxable year beginning after December 31, 1969, the recognized losses from the involuntary conversion as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) exceed the recognized gains from the involuntary conversion of any such property as a result of fire, storm, shipwreck, or other casualty, or from theft, such gains and losses are not gains and losses to which section 1231 applies and shall not be taken into account in applying the provisions of this section. The net loss, in effect, will be treated as an ordinary loss. This subparagraph shall apply whether such property is uninsured, partially insured, or totally insured and, in the case of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), whether the property is property used in the trade or business, property held for the production of income, or a personal asset.

(f) *Unharvested crops.* Section 1231 does not apply to a sale, exchange, or involuntary conversion of an unharvested crop if the taxpayer retains any right or option to reacquire the land the crop is on, directly or indirectly (other than a right customarily incident to a mortgage or other security transaction). The length of time for which the crop, as distinguished from the land, is held is immaterial. A leasehold or estate for years is not *land* for the purpose of section 1231.

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

Example 1. A, an individual, makes his income tax return on the calendar year basis. A's recognized gains and losses for 1957 of the kind described in section 1231 are as follows:

	Gains	*Losses*
1. Gain on sale of machinery, used in the business and subject to an allowance for depreciation, held for more than 6 months	$4,000	
2. Gain reported in 1957 (under section 453) on installment sale in 1956 of factory premises used in the business (including building and land, each held for more than 6 months)	6,000	
3. Gain reported in 1957 (under section 453) on installment sale in 1957 of land held for more than 6 months, used in the business as a storage lot for trucks	2,000	
4. Gain on proceeds from requisition by Government of boat, held for more than 6 months, used in the business and subject to an allowance for depreciation	500	
5. Loss upon the destruction by fire of warehouse, held for more than 6 months and used in the business (excess of adjusted basis of warehouse over compensation by insurance, etc.)		$3,000
6. Loss upon theft of unregistered bearer bonds, held for more than 6 months	.....	5,000
7. Loss in storm of pleasure yacht, purchased in 1950 for $1,800 and having a fair market value of $1,000 at the time of the storm		1,000
8. Total gains	12,500	
9. Total losses		9,000
10. Excess of gains over losses	3,500	

Since the aggregate of the recognized gains ($12,500) exceeds the aggregate of the recognized losses ($9,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months. For any taxable year beginning after December 31, 1957, and before January 1, 1970, the $5,000 loss upon theft of bonds (item 6) would not be

taken into account under section 1231. See paragraph (e)(2) of this section.

Example 2. If in example (1), A also had a loss of $4,000 from the sale under threat of condemnation of a capital asset acquired for profit and held for more than six months, then the gains ($12,500) would not exceed the losses ($9,000 plus $4,000, or $13,000). Neither the loss on that sale nor any of the other items set forth in example (1) would then be treated as gains and losses from the sale or exchanges of capital assets, but all of such items would be treated as ordinary gains and losses. Likewise, if A had no other gain or loss, the $4,000 loss would be treated as an ordinary loss.

Example 3. A's yacht, used for pleasure and acquired for that use in 1945 at a cost of $25,000, was requisitioned by the Government in 1957 for $15,000. A sustained no loss deductible under section 165(c) and since no loss with respect to the requisition is recognizable, the loss will not be included in the computations under section 1231.

Example 4. A, an individual, makes his income tax return on a calendar year basis. During 1970 trees on A's residential property which were planted in 1950 after the purchase of such property were destroyed by fire. The loss, which was in the amount of $2,000 after applying section 165(c)(3), was not compensated for by insurance or otherwise. During the same year A also recognized a $1,500 gain from insurance proceeds compensating him for the theft sustained in 1970 of a diamond brooch purchased in 1960 for personal use. A has no other gains or losses for 1970 from the involuntary conversion of property. Since the recognized losses exceed the recognized gains from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months, neither the gain nor the loss is included in making the computations under section 1231.

Example 5. The facts are the same as in example (4), except that A also recognized a gain of $1,000 from insurance proceeds compensating him for the total destruction by fire of a truck, held for more than 6 months, used in A's business and subject to an allowance for depreciation. A has no other gains or losses for 1970 from the involuntary conversion of property. Since the recognized losses ($2,000) do not exceed the recognized gains ($2,500) from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months, such gains and losses are included in making the computations under section 1231. Thus, if A has no other gains or losses for 1970 to which section 1231 applies, the gains and losses from these involuntary conversions are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months.

Example 6. The facts are the same as in example (5) except that A also has the following recognized gains and losses for 1970 to which section 1231 applies:

	Gains	*Losses*
Gain on sale of machinery, used in the business and subject to an allowance for depreciation, held for more than 6 months	$4,000	
Gain reported in 1970 (under section 453) on installment sale in 1969 of factory premises used in the business (including building and land, each held for more than 6 months)	6,000	
Gain reported in 1970 (under section 453) on installment sale in 1970 of land held for more than 6 months, used in the business as a storage lot for trucks	$2,000	
Loss upon the sale in 1970 of warehouse, used in the business and subject to an allowance for depreciation, held for more than 6 months		$5,000
Total gains	12,000	
Total losses		5,000

Since the aggregate of the recognized gains ($14,500) exceeds the aggregate of the recognized losses ($7,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months.

Example 7. B, an individual, makes his income tax return on the calendar year basis. During 1970 furniture used in his business and held for more than 6 months was destroyed by fire. The recognized loss, after compensation by insurance, was $2,000. During the same year B recognized a $1,000 gain upon the sale of a parcel of real estate used in his business and held for more than 6 months, and a $6,000 loss upon the sale of stock held for more than 6 months. B has no other gains or losses for 1970 from the involuntary conversion, or the sale or exchange of, property. The $6,000 loss upon the sale of stock is not a loss to which section 1231 applies since the stock is not property used in the trade or business, as defined in section 1231(b). The $2,000 loss upon the destruction of the furniture is not a loss to which section 1231 applies since the recognized losses ($2,000) exceed the recognized gains ($0) from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months. Accordingly, the $1,000 gain upon the sale of real estate is considered to be gain from the sale or exchange of a capital asset held for more than 6 months since the gains ($1,000) to which section 1231 applies exceed the losses ($0) to which such section applies.

Example 8. The facts are the same as in example (7) except that B also recognized a gain of $4,000 from insurance proceeds compensating him for the total destruction by fire of a freighter, held for more than 6 months, used in B's business and subject to an allowance for depreciation. Since the recognized losses ($2,000) do not exceed the recognized gains ($4,000) from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months, such gains and losses are included in making the computations under section 1231. Since the aggregate of the recognized gains to which section 1231 applies ($5,000) exceeds the aggregate of the recognized losses to which such section applies ($2,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months. The $6,000 loss upon the sale of stock is not taken into account in making such computation since it is not a loss to which section 1231 applies.

[T.D. 6500, 25 FR 12006, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9309, July 27, 1965; T.D. 7369, 40 FR 29841, July 16, 1975; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7829, 47 FR 38515, Sept. 1, 1982]

§ 1.1231–2 Livestock held for draft, breeding, dairy, or sporting purposes.

(a)(1) In the case of cattle, horses, or other livestock acquired by the taxpayer after December 31, 1969, section 1231 applies to the sale, exchange, or involuntary conversion of such cattle, horses, or other livestock, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him:

(i) For 24 months or more from the date of acquisition in the case of cattle or horses, or

(ii) For 12 months or more from the date of acquisition in the case of such other livestock.

(2) In the case of livestock (including cattle or horses) acquired by the taxpayer on or before December 31, 1969, section 1231 applies to the sale, exchange, or involuntary conversion of such livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition.

(3) For the purposes of section 1231, the term *livestock* is given a broad, rather than a narrow, interpretation and includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals. However, it does not include poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc.

(b)(1) Whether or not livestock is held by the taxpayer for draft, breeding, dairy, or sporting purposes depends upon all of the facts and circumstances in each case. The purpose for which the animal is held is ordinarily shown by the taxpayer's actual use of the animal. However, a draft, breeding, dairy, or sporting purpose may be present if an animal is disposed of within a reasonable time after its intended use for such purpose is prevented or made undesirable by reason of accident, disease, drought, unfitness of the animal for such purpose, or a similar factual circumstance. Under certain circumstances, an animal held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business may be considered as held for draft, breeding, dairy, or sporting purposes. However, an animal is not held by the taxpayer for draft, breeding, dairy, or sporting purposes merely because it is suitable for such purposes or merely because it is held by the taxpayer for sale to other persons for use by them for such purposes. Furthermore, an animal held by the taxpayer for other purposes is not considered as held for draft, breeding, dairy, or sporting purposes merely because of a negligible use of the animal for such purposes or merely because of the use of the animal for such purposes as an ordinary or necessary incident to the other purposes for which the animal is held. See paragraph (c) of this section for the rules to be used in determining when horses are held for racing purposes and, therefore, are considered as held for sporting purposes.

(2) The application of this paragraph is illustrated by the following examples:

Example 1. An animal intended by the taxpayer for use by him for breeding purposes is discovered to be sterile or unfit for the breeding purposes for which it was held, and is disposed of within a reasonable time thereafter. This animal is considered as held for breeding purposes.

Example 2. The taxpayer retires from the breeding or dairy business and sells his entire herd, including young animals which would have been used by him for breeding or dairy purposes if he had remained in business. These young animals are considered as held for breeding or dairy purposes. The same would be true with respect to young animals which would have been used by the taxpayer for breeding or dairy purposes but which are sold by him in reduction of his breeding or dairy herd, because of, for example, drought.

Example 3. A taxpayer in the business of raising hogs for slaughter customarily breeds sows to obtain a single litter to be raised by him for sale, and sells these brood sows after obtaining the litter. Even though these brood sows are held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business, they are considered as held for breeding purposes.

Example 4. A taxpayer in the business of raising horses for sale to others for use by them as draft horses uses them for draft purposes on his own farm in order to train them. This use is an ordinary or necessary incident to the purpose of selling the animals, and, accordingly, these horses are not considered as held for draft purposes.

Example 5. The taxpayer is in the business of raising registered cattle for sale to others for use by them as breeding cattle. It is the business practice of this particular taxpayer to breed the offspring of his herd which he is holding for sale to others prior to sale in order to establish their fitness for sale as registered breeding cattle. In such case, the taxpayer's breeding of such offspring is an ordinary and necessary incident to his holding them for the purpose of selling them as bred heifers or proven bulls and does not demonstrate that the taxpayer is holding them for breeding purposes. However, those cattle held by the taxpayer as additions or replacements to his own breeding herd to produce calves are considered to be held for breeding purposes, even though they may not actually have produced calves.

Example 6. A taxpayer, engaged in the business of buying cattle and fattening them for slaughter, purchased cows with calf. The calves were born while the cows were held by the taxpayer. These cows are not considered as held for breeding purposes.

(c)(1) For purposes of paragraph (b) of this section, a horse held for racing purposes shall be considered as held for sporting purposes. Whether a horse is held for racing purposes shall be determined in accordance with the following rules:

(i) A horse which has actually been raced at a public race track shall, except in rare and unusual circumstances, be considered as held for racing purposes.

(ii) A horse which has not been raced at a public track shall be considered as held for racing purposes if it has been trained to race and other facts and circumstances in the particular case also indicate that the horse was held for this purpose. For example, assume that the taxpayer maintains a written training record on all horses he keeps in training status, which shows that a particular horse does not meet objective standards (including, but not limited to, such considerations as failure to achieve predetermined standards of performance during training, or the existence of a physical or other defect) established by the taxpayer for determining the fitness and quality of horses to be retained in his racing stable. Under such circumstances, if the taxpayer disposes of the horse within a reasonable time after he determined that it did not meet his objective standards for retention, the horse shall be considered as held for racing purposes.

(iii) A horse which has neither been raced at a public track nor trained for racing shall not, except in rare and unusual circumstances, be considered as held for racing purposes.

(2) This paragraph may be illustrated by the following examples:

Example 1. The taxpayer breeds, raises, and trains horses for the purpose of racing. Every year he culls some horses from his racing stable. In 1971, the taxpayer decided that in order to prevent his racing stable from getting too large to be effectively operated he must cull six horses from it. All six of the horses culled by the taxpayer had been raced at public tracks in 1970. Under subparagraph (1)(i) of this paragraph, all these horses are considered as held for racing purposes.

Example 2. Assume the same facts as in example (1). Assume further that the taxpayer decided to cull four more horses from his racing stable in 1971. All these horses had been trained to race but had not been raced at public tracks. The taxpayer culled these four horses because the training log which the taxpayer maintains on all the horses he trains showed these horses to be unfit to remain in his racing stable. Horse A was culled because it developed shin splints during training. Horses B and C were culled because of poor temperament. B bolted every time a rider tried to mount it, and C became extremely nervous when it was placed in the starting gate. Horse D was culled because it

did not qualify for retention under one of the objective standards the taxpayer had established for determining which horses to retain since it was unable to run a specified distance in a minimum time. These four horses were disposed of within a reasonable time after the taxpayer determined that they were unfit to remain in his stable. Under subparagraph (1)(ii) of this paragraph, all these horses are considered as held for racing purposes.

[T.D. 7141, 36 FR 18792, Sept. 22, 1971]

§ 1.1232–1 Bonds and other evidences of indebtedness; scope of section.

(a) *In general.* Section 1232 applies to any bond, debenture, note, or certificate or other evidence of indebtedness (referred to in this section and §§ 1.1232–3 and 1.1232–3A as an obligation) which is a capital asset in the hands of the taxpayer, and which is issued by any corporation, or by any government or political subdivision thereof. In general, section 1232(a)(1) provides that the retirement of an obligation, other than certain obligations issued before January 1, 1955, is considered to be an exchange and, therefore, is usually subject to capital gain or loss treatment. In general, section 1232(a)(2)(B) provides that in the case of a gain realized on the sale or exchange of certain obligations issued at a discount after December 31, 1954, which are either corporate bonds issued on or before May 27, 1969, or government bonds, the amount of gain equal to such discount or, under certain circumstances, the amount of gain equal to a specified portion of such discount, constitutes ordinary income. In the case of certain corporate obligations issued after May 27, 1969, in general, section 1232(a)(3) provides for the inclusion as interest in gross income of a ratable portion of original issue discount for each taxable year over the life of the obligation, section 1232(a)(3)(E) provides for an increase in basis equal to the original issue discount included in gross income, and section 1232(a)(2)(A) provides that any gain realized on such an obligation held more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) shall be considered gain from the sale or exchange of a capital asset held more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). For the requirements for reporting original issue discount on certain obligations issued after May 27, 1969, see section 6049(a) and the regulations thereunder. Section 1232(c) treats as ordinary income a portion of any gain realized upon the disposition of coupon obligations which were acquired after August 16, 1954, and before January 1, 1958, without all coupons maturing more than 12 months after purchase attached, and coupon obligations which were acquired after December 31, 1957, without all coupons maturing after the date of purchase attached.

(b) *Requirement that obligations be capital assets.* In order for section 1232 to be applicable, an obligation must be a capital asset in the hands of the taxpayer. See section 1221 and the regulations thereunder. Obligations held by a dealer in securities (except as provided in section 1236) or obligations arising from the sale of inventory or personal services by the holder are not capital assets. However, obligations held by a financial institution, as defined in section 582(c) (relating to treatment of losses and gains on bonds of certain financial institutions) for investment and not primarily for sale to customers in the ordinary course of the financial institution's trade or business, are capital assets. Thus, with respect ot obligations held as capital assets by such a financial institution which are corporate obligations to which section 1232(a)(3) applies, there is ratable inclusion of original issue discount as interest in gross income under paragraph (a) of § 1.1232–3A, and gain on a sale or exchange (including retirement) may be subject to ordinary income treatment under section 582(c) and paragraph (a)(1) of § 1.1232–3.

(c) *Face-amount certificates*—(1) *In general.* For purposes of section 1232, this section and §§ 1.1232–3 and 1.1232–3A, the term *other evidence of indebtedness* includes *face amount certificates* as defined in section 2(a)(15) and 4 of the Investment Company Act of 1940 (15 U.S.C. 80a–2 and 80a–4).

(2) *Amounts received in taxable years beginning prior to January 1, 1964.* Amounts received in taxable years beginning prior to January 1, 1964 under face amount certificates which were

issued after December 31, 1954, are subject to the limitation on tax under section 72(e)(3). See paragraph (g) of § 1.72–11 (relating to limit on tax attributable to receipt of a lump sum received as an annuity payment). However, section 72(e)(3) does not apply to any such amounts received in taxable years beginning after December 31, 1963.

(3) *Certificates issued after December 31, 1975.* In the case of a face-amount certificate issued after December 31, 1975 (other than such a certificate issued pursuant to a written commitment which was binding on such date and at all times thereafter), the provisions of section 1232(a)(3) (relating to the ratable inclusion of original issue discount in gross income) shall apply. See section 1232–3A(f). For treatment of any increase in basis under section 1232(a)(3)(A) as consideration paid for purposes of computing the investment in the contract under section 72, see § 1.72–6(c)(4).

(d) *Certain deposits in financial institutions.* For purposes of section 1232, this section and §§ 1.1232–3 and 1.1232–3A, the term *other evidence of indebtedness* includes certificates of deposit, time deposits, bonus plans, and other deposit arrangements with banks, domestic building and loan associations, and similar financial institutions. For application of section 1232 to such deposits, see paragraph (e) of § 1.1232–3A. However, section 1232, this section, and §§ 1.1232–2 through 1.1232–4 shall not apply to such deposits made prior to January 1, 1971. For treatment of renewable certificates of deposit, see paragraph (e)(4) of § 1.1232–3A.

[T.D. 7154, 36 FR 25000, Dec. 28, 1971, as amended by T.D. 7311, 39 FR 11880, Apr. 1, 1974; T.D. 7365, 40 FR 27936, July 2, 1975; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 9849, 84 FR 9237, Mar. 14, 2019]

§ 1.1232–2 [Reserved]

§ 1.1232–3 Gain upon sale or exchange of obligations issued at a discount after December 31, 1954.

(a) *General rule; sale or exchange*—(1) *Obligations issued by a corporation after May 27, 1969*—(i) *General rule.* Under section 1232(a)(2)(A), in the case of gain realized upon the sale or exchange of an obligation issued at a discount by a corporation after May 27, 1969 (other than an obligation subject to the transitional rule of subparagraph (4) of this paragraph), and held by the taxpayer for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977):

(*a*) If at the time of original issue there was no intention to call the obligation before maturity, such gain shall be considered as long-term capital gain, or

(*b*) If at the time of original issue there was an intention to call the obligation before maturity, such gain shall be considered ordinary income to the extent it does not exceed the excess of:

(*1*) An amount equal to the entire *original issue discount*, over

(*2*) An amount equal to the entire *original issue discount* multiplied by a fraction the numerator of which is the sum of the number of complete months and any fractional part of a month elapsed since the date of original issue and the denominator of which is the number of complete months and any fractional part of a month from the date of original issue to the stated maturity date.

The balance, if any, of the gain shall be considered as long-term capital gain. The amount described in (*2*) of this subdivision (*b*) in effect reduces the amount of original issue discount to be treated as ordinary income under this subdivision (*b*) by the amounts previously includible (regardless of whether included) by all holders (computed, however, as to any holder without regard to any purchase allowance under paragraph (a)(2)(ii) of § 1.1232–3A and without regard to whether any holder purchased at a premium as defined in paragraph (d)(2) of § 1.1232–3).

(ii) *Cross references.* For definition of the terms *original issue discount* and *intention to call before maturity*, see paragraphs (b) (1) and (4) respectively of this section. For definition of the term *date of original issue*, see paragraph (b)(3) of this section. For computation of the number of complete months and any fractional portion of a month, see paragraph (a)(3) of § 1.1232–3A.

(iii) *Effect of section 582(c).* Gain shall not be considered to be long-term capital gain under subdivision (i) of this subparagraph if section 582(c) (relating

to treatment of losses and gains on bonds of certain financial institutions) applies.

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

Example 1. On January 1, 1970, A, a calendar-year taxpayer, purchases at original issue for cash of $7,600, M Corporation's 10-year, 5 percent bond which has a stated redemption price at maturity of $10,000. On January 1, 1972, A sells the bond to B, for $9,040. A has previously included $480 of the original issue discount in his gross income (see example (1) of paragraph (d) of §1.1232–3A) and increased his basis in the bond by that amount to $8,080 (see paragraph (c) of §1.1232–3A). Thus, if at the time of original issue there was no intention to call the bond before maturity, A's gain of $960 (amount realized, $9,040, less adjusted basis, $8,080) is considered long-term capital gain.

Example 2. (i) Assume the same facts as in example (1), except that at the time of original issue there was an intention to call the bond before maturity. The amount of the entire gain includible by A as ordinary income under subparagraph (1)(i) of this paragraph is determined as follows:

(1) Entire original issue discount (stated redemption price at maturity, $10,000, minus issue price, $7,600)	$2,400
(2) Less: Line (1), $2,400, multiplied by months elapsed since date of original issue, 24, divided by months from such date to stated maturity date, 120	$480
(3) Maximum amount includible by A as ordinary income	$1,920

Since the amount in line (3) is greater than A's gain, $960, A's entire gain is includible as ordinary income.

(ii) On January 1, 1979, B, a calendar-year taxpayer, sells the bond to C for $10,150. Assume that B has included $120 of original issue discount in his gross income for each taxable year he held the bond (see example (2) of paragraph (d) of §1.1232–3A) and therefore increased his basis by $840 (i.e., $120 each year × 7 years) to $9,880. B's gain is therefore $270 (amount realized, $10,150, less basis, $9,880). The amount of such gain includible by B as ordinary income under subparagraph (1)(i) of this paragraph is determined as follows:

(1) Entire original issue discount (as determined in part (i) of this example)	$2,400
(2) Less: Line (1), $2,400, multiplied by months elapsed since date of original issue, 108, divided by months from such date to stated maturity date, 120	$2,160
(3) Maximum amount includible by B as ordinary income	$240

Since the amount in line (3) is less than B's gain, $270, only $240 of B's gain is includible as ordinary income. The remaining portion of B's gain, $30, is considered long-term capital gain.

(3) *Obligations issued by a corporation on or before May 27, 1969, and government obligations*. Under section 1232(a)(2)(B), if gain is realized on the sale or exchange after December 31, 1957, of an obligation held by the taxpayer more than 6 months, and if the obligation either was issued at a discount after December 31, 1954, and on or before May 27, 1969, by a corporation or was issued at a discount after December 31, 1954, by or on behalf of the United States or a foreign country, or a political subdivision of either, then such gain shall be considered ordinary income to the extent it does not exceed:

(i) An amount equal to the entire *original issue discount*, or

(ii) If at the time of original issue there was no intention to call the obligation before maturity, a portion of the *original issue discount* determined in accordance with paragraph (c) of this section,

And the balance, if any, of the gain shall be considered as long-term capital gain. For the definition of the terms *original issue discount* and *intention to call before maturity*, see paragraphs (b) (1) and (4) respectively of this section. See section 1037(b) and paragraph (b) of §1.1037–1 for special rules which are applicable in applying section 1232(a)(2)(B) and this subparagraph to gain realized on the disposition or redemption of obligations of the United States which were received from the United States in an exchange upon which gain or loss is not recognized because of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)).

(4) *Transitional rule*. Subparagraph (3) of this paragraph (in lieu of subparagraph (1) of this paragraph) shall apply to an obligation issued by a corporation pursuant to a written commitment which was binding on May 27, 1969, and at all times thereafter.

(5) *Obligations issued after December 31, 1954, and sold or exchanged before January 1, 1958*. Gain realized upon the sale or exchange before January 1, 1958, of an obligation issued at a discount after

December 31, 1954, and held by the taxpayer for more than 6 months, shall be considered ordinary income to the extent it equals a specified portion of the *original issue discount,* and the balance, if any, of the gain shall be considered as long-term capital gain. The term *original issue discount* is defined in paragraph (b)(1) of this section. The computation of the amount of gain which constitutes ordinary income is illustrated in paragraph (c) of this section.

(6) *Obligations issued before January 1, 1955.* Whether gain representing original issue discount realized upon the sale or exchange of obligations issued at a discount before January 1, 1955, is capital gain or ordinary income shall be determined without reference to section 1232.

(b) *Definitions*—(1) *Original issue discount*—(i) *In general.* For purposes of section 1232, the term *original issue discount* means the difference between the issue price and the stated redemption price at maturity. The stated redemption price is determined without regard to optional call dates.

(ii) *De minimis rule.* If the original issue discount is less than one-fourth of 1 percent of the stated redemption price at maturity multiplied by the number of full years from the date of original issue to maturity, then the discount shall be considered to be zero. For example, a 10-year bond with a stated redemption price at maturity of $100 issued at $98 would be regarded as having an original issue discount of zero. Thus, any gain realized by the holder would be a long-term capital gain if the bond was a capital asset in the hands of the holder and held by him for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). However, if the bond were issued at $97.50 or less, the original issue discount would not be considered zero.

(iii) *Stated redemption price at maturity*—(*a*) Definition. Except as otherwise provided in this subdivision (iii), the term *stated redemption price at maturity* means the amount fixed by the last modification of the purchase agreement, including dividends, interest, and any other amounts, however designated, payable at that time. If any amount based on a fixed rate of simple or compound interest is actually payable or will be treated as constructively received under section 451 and the regulations thereunder either: (*1*) At fixed periodic intervals of one year or less during the entire term of an obligation, or (*2*) except as provided in subdivision (*e*) of this paragraph (b)(1)(iii), at maturity in the case of an obligation with a term of one year or less, any such amount payable at maturity shall not be included in determining the stated redemption price at maturity. For purposes of subdivision (*a*)(*2*) of this paragraph (b)(1)(iii), the term of an obligation shall include any renewal period with respect to which, under the terms of the obligation, the holder may either take action or refrain from taking action which would prevent the actual or constructive receipt of any interest on such obligation until the expiration of any such renewal period. To illustrate this paragraph (b)(1)(iii), assume that a note which promises to pay $1,000 at the end of three years provides for additional amounts labeled as interest to be paid at the rate of $50 at the end of the first year, $50 at the end of the second year, and $120 at the end of the third year. The stated redemption price at maturity will be $1,070 since only $50 of the $120 payable at the end of the third year is based on a fixed rate of simple or compound interest. If, however, the $120 were payable at the end of the second year, so that only $50 in addition to principal would be payable at the end of the third year, then under the rule for serial obligations contained in subparagraph (2)(iv)(*c*) of this paragraph, the $1,000 note is treated as consisting of two series. The first series is treated as maturing at the end of the second year at a stated redemption price of $70. The second series is treated as maturing at the end of the third year at a stated redemption price of $1,000. For the calculation of issue price and the allocation of original issue discount with respect to each such series, see example (3) of subparagraph (2)(iv)(*f*) of this paragraph.

(*b*) *Special rules.* In the case of face-amount certificates, the redemption price at maturity is the price as modified through changes such as extensions of the purchase agreement and

includes any dividends which are payable at maturity. In the case of an obligation issued as part of an investment unit consisting of such obligation and an option (which is not excluded by (*c*) of this subdivision (iii)), security, or other property, the term *stated redemption price at maturity* means the amount payable on maturity in respect of the obligation, and does not include any amount payable in respect of the option, security, or other property under a repurchase agreement or option to buy or sell the option, security, or other property. For application of this subdivision to certain deposits in financial institutions, see paragraph (e) of § 1.1232–3A.

(*c*) *Excluded option*. An option is excluded by this subdivision (c) if it is an option to which paragraph (a) of § 1.61–15 applies or if it is an option, referred to in paragraph (a) of § 1.83–7, granted in connection with performance of services to which section 421 does not apply.

(*d*) *Obligation issued in installments*. If an obligation is issued by a corporation under terms whereby the holder makes installment payments, then the stated redemption price for each installment payment shall be computed in a manner consistent with the rules contained in subparagraph (2)(iv) of this paragraph for computing the issue price for each series of a serial obligation. For application of this subdivision (*d*) to certain open account deposit arrangements, see examples (1) and (2) of paragraph (e)(5)(ii) of § 1.1232–3A.

(*e*) *Application of definition*. Subdivision (*a*)(*2*) of this paragraph (b)(1)(iii) shall not apply:

(*1*) For taxable years beginning before September 19, 1979, if for the issuer's last taxable year beginning before September 19, 1978, the rules of § 1.163–4 were properly applied by the issuer, or

(*2*) In the case of an obligation with a term of six months or less held by a nonresident alien individual or foreign corporation, but only for purposes of the appliction of sections 871 and 881.

(iv) *Carryover of original issue discount*. If in pursuance of a plan of reorganization an obligation is received in an exchange for another obligation, and if gain or loss is not recognized in whole or in part on such exchange of obligations by reason, for example, of section 354 or 356, then the obligation received shall be considered to have the same original issue discount as the obligation surrendered reduced by the amount of gain (if any) recognized as ordinary income upon such exchange of obligations, and by the amount of original issue discount with respect to the obligation surrendered which was included as interest income under the ratable inclusion rules of sections 1232(a)(3) and 1.1232–3A. If inclusion as interest of the ratable monthly portion of original issue discount is required under section 1232(a)(3) with respect to the obligation received, see paragraph (a)(2)(iii) of § 1.1232–3A for computation of the ratable monthly portion of original issue discount. For special rules in connection with certain exchanges of U.S. obligations, see section 1037.

(2) *Issue price defined*—(i) *In general*. The term *issue price* in the case of obligations registered with the Securities and Exchange Commission means the initial offering price to the public at which price a substantial amount of such obligations were sold. For this purpose, the term *the public* does not include bond houses and brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers. Ordinarily, the issue price will be the first price at which the obligations were sold to the public, and the issue price will not change if, due to market developments, part of the issue must be sold at a different price. When obligations are privately placed, the issue price of each obligation is the price paid by the first buyer of the particular obligation, irrespective of the issue price of the remainder of the issue. In the case of an obligation issued by a foreign obligor, the issue price shall be increased by the amount, if any, of interest equalization tax paid under section 4911 (and not credited, refunded, or reimbursed) on the acquisition of the obligation by the first buyer. In the case of an obligation which is convertible into stock or another obligation, the issue price includes any amount paid in respect of the conversion privilege. However, in the case of an obligation issued as part of an investment unit (as defined in

subdivision (ii)(*a*) of this subparagraph), the issue price of the obligation includes only that portion of the initial offering price or price paid by the first buyer properly allocable to the obligation under the rules prescribed in subdivision (ii) of this subparagraph. The terms *initial offering price* and *price paid by the first buyer* include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof. Thus, all amounts paid by the purchaser under the purchase agreement or a modification of it are included in the issue price (but in the case of an obligation issued as part of an investment unit, only to the extent allocable to such obligation under subdivision (ii) of this subparagraph), such as amounts paid upon face-amount certificates or installment trust certificates in which the purchaser contracts to make a series of payments which will be returnable to the holder with an increment at a later date.

(ii) *Investment units consisting of obligations and property—(a) In general.* An investment unit, within the meaning of this subdivision (ii) and for purposes of section 1232, consists of an obligation and an option, security, or other property. For purposes of this subparagraph, the initial offering price of an investment unit shall be allocated to the individual elements of the unit on the basis of their respective fair market values. However, if the fair market value of the option, security, or other property is not readily ascertainable (within the meaning of paragraph (c) of § 1.421–6), then the portion of the initial offering price or price paid by the first buyer of the unit which is allocable to the obligation issued as part of such unit shall be ascertained as of the time of acquisition of such unit by reference to the assumed price at which such obligation would have been issued had it been issued apart from such unit. The assumed price of the obligation shall be ascertained by comparison to the yields at which obligations of a similar character which are not issued as part of an investment unit are sold in arm's length transactions, and by adjusting the price of the obligation in question to this yield. The adjustment may be made by subtracting from the face amount of the obligation the total present value of the interest foregone by the purchaser as a result of purchasing the obligation at a lower yield as part of an investment unit. In most cases, assumed price may also be determined in a similar manner through the use of standard bond tables. Any reasonable method may be used in selecting an obligation for comparative purposes. Obligations of the same grade and classification shall be used to the extent possible, and proper regard shall be given, with respect to both the obligation in question and the comparative obligation, to the solvency of the issuer, the nature of the issuer's trade or business, the presence and nature of security for the obligation, the geographic area in which the loan is made, and all other factors relevant to the circumstances. An obligation which is convertible into stock or another obligation must not be used as a comparative obligation (except where the investment unit contains an obligation convertible into stock or another obligation), since such an obligation would not reflect the yield attributable solely to the obligation element of the investment unit.

(*b*) *Agreement as to assumed price.* In the case of an investment unit which is privately placed, the assumed price at which the obligation would have been issued had it been issued apart from such unit may be agreed to by the issuer and the original purchaser of the investment unit in writing on or before the date of purchase. Alternatively, an agreement between the issuer and original purchaser may specify the rate of interest which would have been paid on the obligation if the transaction were one not involving the issuance of options, and an assumed issue price may be determined (in the manner described in (*a*) of this subdivision) from such agreed assumed rate of interest. An assumed price based upon such an agreement between the parties will generally be presumed to be the issue price of the obligation with respect to the issuer, original purchaser, and all subsequent holders: *Provided*, That the agreement was made in arm's length negotiations between parties having adverse interests: *And, provided further*, That such price does not, under the

rules stated in (*a*) of this subdivision, appear to be clearly erroneous. An assumed issue price agreed to by the parties as provided herein will not be considered clearly erroneous if it is not less than the face value adjusted (in the manner described in (*a*) of this subdivision) to a yield which is one percentage point greater than the actual rate of interest payable on the obligation. Similarly, if the agreement between the parties specifies an agreed assumed rate of interest (in lieu of an agreed assumed issue price) and such agreed rate is not more than 1 percentage point greater than the actual rate payable on the obligation, an adjusted issue price based upon such agreed assumed rate of interest will not be considered clearly erroneous.

(*c*) *Cross references.* For rules relating to the deductibility by the issuing corporation of bond discount resulting from an allocation under the rule stated in (*a*) of this subdivision, see §§ 1.163–3 and 1.163–4. For rules relating to the basis of obligations and options, securities, or other property acquired in investment units, see § 1.1012–1(d). For rules relating to certain reporting requirements with respect to options acquired in connection with evidences of indebtedness and for the tax treatment of such options, see § 1.61–15, and section 1234 and the regulations thereunder. With respect to the tax consequences to the issuing corporation upon the exercise of options issued in connection with evidences of indebtedness to which this section applies, see section 1032 and the regulations thereunder.

(*d*) *Examples.* The application of the principles set forth in this subdivision (ii) may be illustrated by the following examples in each of which it is assumed that there was no intention to call the note before maturity:

Example 1. M Corporation is a small manufacturer of electronic components located in the southwestern United States. On January 1, 1969, in consideration for the payment of $41,500, M issues to X its unsecured note for $40,000 together with warrants to purchase 3,000 shares of M stock at $10 per share at any time during the term of the note. The note is payable in 4 years and provides for interest at the rate of 5 percent per year, payable semiannually. The fair market values of the note and the warrants are not readily ascertainable. Assume that companies in the same industry as M Corporation, and similarly situated both financially and geographically, are generally able to borrow money on their unsecured notes at an annual interest rate of 6 percent. Using a present value table, the calculation of the issue price of a 5 percent, 4 year, $40,000 note, discounted to yield 6 percent compounded semiannually is made as follows:

(1)	(2)	(3)	(2) × (3)
Semiannual interest period	Amount payable at 5 percent	Factor for present value discounted at 3 percent per period	Present value of payment
1	$1,000	0.9709	$970.90
2	1,000	.9426	942.60
3	1,000	.9151	915.10
4	1,000	.8885	888.50
5	1,000	.8626	862.60
6	1,000	.8375	837.50
7	1,000	.8131	813.10
8	1,000	.7894	789.40
8	40,000	.7804	31,576.00
Total present value of note discounted at 6 percent, compounded semiannually			38,595.70

The same result may be reached through the use of a standard bond table or by the following present value calculation:

Present value of annuity of $1,000 payable over 8 periods at 3 percent per period = 1000 × 7.0197 =	$7,019.70
Add: Present value of principal (as calculated above)	31,576.00
Total	$38,595.70

Accordingly, the assumed price at which M's note would have been issued had it been issued without stock purchase warrants, i.e., that portion of the $41,500 price paid by X which is allocable to M's note, is $38,596 (rounded). Since the price payable on redemption of M's note at maturity is $40,000, the original issue discount on M's note is $1,404 ($40,000 minus $38,596). Under the rules stated in § 1.163–3, M is entitled to a deduction, to be prorated or amortized over the life of the note, equal to this original issue discount on the note. The excess of the price for the unit over the portion of such price allocable to the note, $2,904 ($41,500 minus $38,596), is allocable to and is the basis of the stock purchase warrants acquired by X in connection with M's note. Upon the exercise of X's warrants, M will be allowed no deduction and will have no income. Upon maturity of the note X will receive $40,000 from M, of which $1,404, the amount of the original issue discount, will be taxable as ordinary income. If X were to transfer the note at its face amount to A 2 years after the issue date, X would realize, under section 1232(a)(2)(B), ordinary income of $702 (one-half of $1,404).

Example 2. (1) On January 1, 1969, N Corporation negotiates with Y, a small business investment company, for a loan in the

amount of $51,500 in consideration of which N Corporation issues to Y its unsecured 5-year note for $50,000, together with warrants to purchase 2,000 shares of N stock at $5 per share at any time during the term of the note. The note provides for interest of 6 percent, payable semiannually. The fair market values of the note and warrants are not readily ascertainable. The loan agreement between Y and N contains a provision, agreed to in arms-length bargaining between the parties, that a rate of 7 percent payable semiannually would have been applied to the loan if warrants were not issued as part of the consideration for the loan. The issue price of the note is $47,921 (rounded), determined with the use of a standard bond table, or computed in the manner illustrated in Example 1 or in the following alternative manner:

(1)	(2)	(3)	(4)	(5)	(4) × (5)
Interest period	Interest rate differential	Principal	Interest foregone for period (½%)	Factor for present value discounted at 3½ percent per period	Present value of interest foregone
1	1%(7%-6%)	$50,000	250	0.9662	$241.53
2	1%	50,000	250	.9335	233.38
3	1%	50,000	250	.9019	225.48
4	1%	50,000	250	.8714	217.85
5	1%	50,000	250	.8420	210.50
6	1%	50,000	250	.8135	203.38
7	1%	50,000	250	.7860	196.50
8	1%	50,000	250	.7594	189.85
9	1%	50,000	250	.7337	183.43
10	1%	50,000	250	.7089	177.25
Total present value of interest foregone					$2,079.15
Principal					50,000.00
Less: Total present value of interest foregone					2,079.15
Issue price					47,920.85

The calculation of present value of interest foregone may also be made as follows:

Present value of annuity of $250 discounted for 10 periods at 3½ percent per period = $250 × 8.3166 = $2,079.15.

The total present value of interest foregone, $2,079, is also the original issue discount attributable to the note ($50,000 − $47,921). Under (*b*) of this subdivision, since the agreed assumed rate of interest of 7 percent is not more than 1 percentage point greater than the actual rate payable on the note, determination of the issue price of the note (and original issue discount) based upon such assumed rate will be presumed to be correct and will not be considered clearly erroneous, provided that both N and Y adhere to such determination. Under the rules in § 1.163–3, N is entitled to a deduction, to be prorated or amortized over the life of the note, equal to the original issue discount on the note. The excess of the price paid for the unit over the portion of such price allocable to the note, $3,579 ($51,500 − $47,921) is allocable to and is the basis of the stock purchase warrants acquired by Y in connection with N's note. Upon the exercise or sale of the warrants by Y, N will be allowed no deduction and will have no income. Upon maturity of the note Y will receive $50,000 from N, of which $2,079, the amount of the original issue discount, will be taxable as ordinary income. If Y were to transfer the note at its face value to B 2½ years after the issue date, Y would realize, under section 1232(a)(2)(B), ordinary income of $1,039.50 (one-half of $2,079).

(2) Assume that instead of the parties agreeing on an assumed interest rate at which the obligation would have been issued without the warrants, the parties agreed that the obligation at the actual 6 percent rate would have been issued without the warrants at a discounted price of $48,000. In this situation the agreed assumed issue price is presumed to be correct since it is not less than the face value adjusted (in the manner illustrated in part (*1*) of this example) to a yield which is one percentage point greater than the actual rate of interest payable on the obligation ($47,921).

Example 3. O Corporation is a small advertising company located in the northeastern United States. Z is a tax-exempt organization. In consideration for the payment of $60,000, O issues to Z, in a transaction not within the scope of section 503(b), its unsecured 5-year note for $60,000, together with warrants to purchase 6,000 shares of O stock at $10 per share at any time during the term of the note. The note is subject to quarterly amortization at the rate of $3,000 per quarter, and provides for interest on the outstanding unpaid balance at an annual rate of 6 percent payable quarterly (1½ percent per quarter). The fair market values of the notes

and warrants are not readily ascertainable. The loan agreement between O and Z contains a recital that if the $60,000 note had been issued without the warrants only $45,000 would have been paid for it. An examination of relevant facts indicates that companies in the same industry as O Corporation, and similarly situated both financially and geographically, are able to borrow money on their unsecured notes at an annual interest cost of 8½ percent payable quarterly (2⅛ percent per quarter). By reference to a present value table, it is found that the present value of O's note discounted to yield 8½ percent compounded quarterly is $56,608 (rounded). The computation is as follows:

(1)	(2)	(3)	(4)	(5)	(6)
Quarterly interest period	Principal payable	Interest payable (1½ percent)	Total amount payable (2) + (3)	Factor for present value discounted at 2⅛ percent per quarter	Present value of total payment (4) × (5)
1	$3,000	$900	$3,900	0.9792	$3,818.88
2	3,000	855	3,855	.9588	3,696.17
3	3,000	810	3,810	.9389	3,577.21
4	3,000	765	3,765	.9193	3,461.16
5	3,000	720	3,720	.9002	3,348.74
6	3,000	675	3,675	.8815	3,239.51
7	3,000	630	3,630	.8631	3,133.05
8	3,000	585	3,585	.8452	3,030.04
9	3,000	540	3,540	.8276	2,929.70
10	3,000	495	3,495	.8104	2,832.35
11	3,000	450	3,450	.7935	2,737.58
12	3,000	405	3,405	.7770	2,645.69
13	3,000	360	3,360	.7608	2,556.29
14	3,000	315	3,315	.7450	2,469.68
15	3,000	270	3,270	.7295	2,385.47
16	3,000	225	3,225	.7143	2,303.62
17	3,000	180	3,180	.6994	2,224.09
18	3,000	135	3,135	.6849	2,147.16
19	3,000	90	3,090	.6706	2,072.15
20	3,000	45	3,045	.6567	1,999.65
Total					56,608.19

This amount ($56,608) is the assumed price at which the note would have been issued had it been issued without stock purchase warrants. The assumed price of $45,000 agreed to by the parties is not presumed to be correct since it is less than the face value adjusted to a yield which is one percentage point greater than the actual rate of interest payable on the obligation. The parties did not have adverse interests in agreeing upon an assumed price (since an excessively large amount of original issue discount would benefit O, the borrower, without adversely affecting Z, an exempt organization which would pay no tax on original issue discount income), and the price agreed to appears to be clearly erroneous when compared to the $56,608 assumed issue price determined under the principles of (*a*) of this subdivision. Since the maturity value of O's note is $60,000, the original issue discount on O's note is $3,392 ($60,000 minus $56,608). Under the rules in § 1.163–3, O is entitled to a deduction, to be prorated or amortized over the life of the note, equal to this original issue discount on the note. The excess of the price paid for the unit over the portion of such price allocable to the note, $3,392 ($60,000 minus $56,608), is allocable to and is the basis of the stock purchase warrants acquired by Z in connection with O's note. Upon the exercise or sale of the warrants by Z, O will be allowed no deduction and will have no income.

(iii) *Issuance for property after May 27, 1969*—(*a*) *In general*. Except as provided in (*b*) of this subdivision, if an obligation or an investment unit is issued for property other than money, the issue price of such obligation shall be the stated redemption price at maturity and, therefore, no original issue discount is created as a result of the exchange. However, in such case, there may be an amount treated as interest under section 483. In the case of certain exchanges of obligations of the United States for other such obligations, see section 1037 for the determination of the amount of original issue discount on the obligation acquired in the exchange. For carryover of original issue discount in the case of certain exchanges of obligations, see subparagraph (1)(iv) of this paragraph.

(*b*) *Exceptions for original issue discount*. If an obligation or investment unit is issued for property in an exchange which is not pursuant to a plan

of reorganization referred to in (*d*) of this subdivision, and if:

(*1*) The obligation, investment unit, or an element of the investment unit is part of an issue a portion of which is traded on an established securities market, or

(*2*) The property for which such obligation or investment unit is issued is stock or securities which are traded on an established securities market

then the issue price of the obligation or investment unit shall be the fair market value of the property for which such obligation or investment unit is issued, as determined under (*c*) of this subdivision. Such issue price shall control for purposes of determining the amount realized by the person exchanging the property for the obligation or unit issued and the bases of the property acquired by the holder and issuer.

An obligation which is not traded on an established securities market and which is not part of an issue or investment unit a portion of which is so traded shall not be treated as property described in (*1*) of this (*b*) even though the obligation is convertible into property so traded. For purposes of this (*b*), an obligation, investment unit, or element of an investment unit shall be treated as traded on an established securities market if it is so traded on or within 10 *trading* days after the date it is issued. *Trading* days shall mean those days on which an established securities market is open. For purposes of this subdivision (iii), the term *established securities market* shall have the same meaning as in paragraph (d)(4) of § 1.453–3 (relating to limitations on installment method for purchaser evidences of indebtedness payable on demand or readily tradable).

(*c*) *Determination of fair market value in cases to which (b) of this subdivision applies*. In general, for purposes of (*b*) of this subdivision, the fair market value of property for which an obligation or investment unit is issued shall be deemed to be the same as the fair market value of such obligation or investment unit, determined by reference to the fair market value of that portion of the issue, of which such obligation or unit is a part, which is traded on an established securities market. The fair market value of such obligation or unit shall be determined as of the first date after the date of issue (within the meaning of section 1232(b)(3)) that such obligation or unit is traded on an established securities market. If, however, the obligation or investment unit is not part of an issue a portion of which is traded on an established securities market, but the property for which the obligation or investment unit is issued is stock or securities which are traded on an established securities market, the fair market value of such property shall be the fair market value of such stock or securities on the date such obligation or unit is issued for such property. The fair market value of property for purposes of this (*c*) shall be determined as provided in § 20.2031–2 of this chapter (Estate Tax Regulations) but without applying the blockage and other special rules contained in paragraph (e) thereof.

(*d*) *Not in reorganization*. An exchange which is not pursuant to a reorganization referred to in this subdivision (*d*) is an exchange in which the obligation or investment unit is not issued pursuant to a plan of reorganization within the meaning of section 368(a)(1) or pursuant to an insolvency reorganization within the meaning of section 371, 373, or 374. Thus, for example, no original issue discount is created on an obligation issued in a recapitalization within the meaning of section 368(a)(1)(E). Similarly, no original issue discount is created on an obligation issued in an exchange, pursuant to a plan of reorganization, to which section 361 applies regardless of the income tax consequences to any person who pursuant to such plan is the ultimate recipient of the obligation. The application of section 351 shall not preclude the creation of original issue discount. For carryover of original issue discount in the case of an exchange of obligations pursuant to a plan of reorganization, see subparagraph (1)(iv) of this paragraph.

(*e*) *Effective date*. Determinations with respect to obligations issued on or before May 27, 1969, or pursuant to a written commitment which was binding on that date and at all times thereafter, shall be made without regard to this subdivision (iii).

(iv) *Serial obligations—(a) In general.* If an issue of obligations which matures serially is issued by a corporation, and if on the basis of the facts and circumstances in such case an independent issue price for each particular maturity can be established, then the obligations with each particular maturity shall be considered a separate series, and the obligations of each such series shall be treated as a separate issue with a separate issue price, maturity date, and stated redemption price at maturity. The ratable monthly portion of original issue discount attributable to each obligation within a particular series shall be determined and ratably included as interest in gross income under the rules of § 1.1232–3A.

(*b*) *Issue price not independently established.* If a separate issue price cannot be established with respect to each series of an issue of obligations which matures serially, the issue price for each obligation of each series shall be its stated redemption price at maturity minus the amount of original issue discount allocated thereto in accordance with (*d*) of this subdivision. The amount of original issue discount so allocated shall be ratably included as interest in gross income under rules of § 1.1232–3A.

(*c*) *Single obligation rule.* If a single corporate obligation provides for payments (other than payments which would not be included in the stated redemption price at maturity under subparagraph (1)(iii) of this paragraph) in two or more installments, the provisions of (*b*) of this subdivision shall be applied by treating such obligation as an issue of obligations consisting of more than one series each of which matures on the due date of each such installment payment.

(*d*) *Allocation of discount.* For purposes of (*b*) and (*c*) of this subdivision, the original issue discount with respect to each series of an issue shall be the total original issue discount for the issue multiplied by a fraction:

(*1*) The numerator of which is the product of (*i*) the stated redemption price of such series and (*ii*) the number of complete years (and any fraction thereof) constituting the period for such series from the date of original issue (as defined in paragraph (b)(3) of this section) to its stated maturity date, and

(*2*) The denominator of which is the sum of the products determined in (*1*) of this subdivision (*d*) with respect to each such series.

If a series consists of more than one obligation, the original issue discount allocated to such series shall be apportioned to such obligations in proportion to the stated redemption price of each. Computations under this subdivision (*d*) may be made using periods other than years, such as, for example, months or periods of 3 months.

(*e*) *Effective date.* The provisions of this subdivision (iv) shall apply with respect to corporate obligations issued after July 22, 1971. However, no inference shall be drawn from the preceding sentence with respect to serial obligations issued prior to such date.

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

Example 1. On January 1, 1972, P Corporation issued a note with a total face value of $100,000 to B for cash of $94,000. The terms of the note provide that $50,000 is payable on December 31, 1973, and the other $50,000 on December 31, 1975. Each payment is treated as the stated redemption price of a series, and the total original issue discount with respect to the note, $6,000, is allocated to each such series as follows:

Year of maturity	1973	1975	Total
(1) Stated redemption price	$50,000	$50,000	
(2) Multiply by years outstanding	2	4	
(3) Product of bond years	$100,000	$200,000	
(4) Sum of products	.....	.....	$300,000
(5) Fractional portion of discount	$100,000	$200,000	
	$300,000	$300,000	
(6) Multiply line (5) by discount for entire issue	$6,000	$6,000	
(7) Discount for each series	$2,000	$4,000	
(8) Issue price (line (1), minus line (7))	$48,000	$46,000	

Example 2. Assume the same facts as in example (1) except that a separate note is issued for each payment. The result is the same as in example (1).

Example 3. On January 1, 1971, Y Bank, a corporation, issues a note to C for $1,000

cash. The terms of the note provide that $50 will be paid at the end of the first year, $120 at the end of the second year, and $1,050 at the end of the third year. Under (*c*) of this subdivision (iv), the $1,000 note is treated as consisting of two series, the first of which matures at the end of the second year, and the second of which matures at the end of the third year. The issue price and the allocation of original issue discount with respect to each series is computed as follows:

Year of maturity	1972	1973	Total
(1) Stated redemption price	$70	$1,000	
(2) Multiply by years outstanding	2	3	
(3) Product of bond years	$140	$3,000	
(4) Sum of products	.....	.....	$3,140
(5) Fractional portion of discount	$140	$3,000	
	$3,140	$3,140	
(6) Multiply line (5) by discount for entire issue	$70	$70	
(7) Discount for each series	$3.12	$66.88	
(8) Issue price (line 1 minus line (7))	$66.88	$933.12	

(3) *Date of original issue*. In the case of issues of obligations which are registered with the Securities and Exchange Commission, the term *date of original issue* means the date on which the issue was first sold to the public at the issue price. In the case of issues which are privately placed, the term *date of original issue* means the date on which each obligation was sold to the original purchaser.

(4) *Intention to call before maturity*—(i) *Meaning of term*. For purposes of section 1232, the term *intention to call the bond or other evidence of indebtedness before maturity* means an understanding between (*a*) the issuing corporation (such corporation is hereinafter referred to as the *issuer*), and (*b*) the original purchaser of such obligation (or, in the case of obligations constituting part of an issue, any of the original purchasers of such obligations) that the issuer will redeem the obligation before maturity. For purposes of this subparagraph, the term *original purchaser* does not include persons or organizations acting in the capacity of underwriters or dealers, who purchased the obligation for resale in the ordinary course of their trade or business. It is not necessary that the issuer's intention to call the obligation before maturity be communicated directly to the original purchaser by the issuer. The understanding to call before maturity need not be unconditional; it may, for example, be dependent upon the financial condition of the issuer on the proposed early call date.

(ii) *Proof of intent*—(*a*) *In general*. Ordinarily, the existence or nonexistance of an understanding at the time of original issue that the obligation will be redeemed before maturity shall be determined by an examination of all of the circumstances under which the obligation was issued and held. The fact that the obligation is issued with provisions on its face giving the issuer the privilege of redeeming the obligation before maturity is not determinative of an intention to call before maturity; likewise, the absence of such provision is not determinative of the absence of an intention to call before maturity. However, such provision, or the absence of such provision, is one of the circumstances to be given consideration along with other factors in determining whether an understanding existed. If the obligation was part of an issue registered with the Securities and Exchange Commission and was sold to the public (whether or not sold directly to the public by the obligor) without representation to the public that the obligor intends to call the obligation before maturity, there shall be a presumption that no intention to call the obligation before maturity was in existence at the time of original issue. The existence of a provision on the face of an obligation giving the issuer the privilege of redeeming the obligation before maturity shall not in and of itself overcome the presumption set forth in the preceding sentence.

(*b*) *Circumstances indicating absence of understanding*. Examples of circumstances which would be evidence that there was no understanding at the time of original issue to redeem the obligation before maturity are:

(*1*) The issue price and term of the obligation appear to be reasonable, taking into account the interest rate,

if any, on the obligation, for a corporation in the financial condition of the issuer at the time of issue.

(*2*) The original purchaser and the issuer are not related within the meaning of section 267(b) and have not engaged in transactions with each other (other than concerning the obligation).

(*3*) The original purchaser is not related within the meaning of section 267(b) to any of the officers or directors of the issuer, and he has not engaged in transactions with such officers or directors (other than concerning the obligation).

(*4*) The officers and directors of the issuer at the time of issue of the obligation are different from those in control at the time the obligation is called or the taxpayer disposes of it.

(*c*) *Gain treated as ordinary income in certain cases; computation.* The amount of gain treated as ordinary income under paragraph (a) (3)(ii) or (5) of this section is computed by multiplying the original issue discount by a fraction, the numerator of which is the number of full months the obligation was held by the holder and the denominator of which is the number of full months from the date of original issue to the date specified as the redemption date at maturity. (See paragraph (b)(3) of this section for definition of *date of original issue.*) The period that the obligation was held by the taxpayer shall include any period that it was held by another person if, under chapter 1 of the Code, for the purpose of determining gain or loss from a sale or exchange, the obligation has the same basis, in whole or in part, in the hands of the taxpayer as it would have in the hands of such other person. This computation is illustrated by the following examples:

Example 1. An individual purchases a 10-year, 3-percent coupon bond for $900 on original issue on February 1, 1955, and sells it on February 20, 1960, for $940. The redemption price is $1,000. At the time of original issue, there was no intention to call the bond before maturity. The bond has been held by the taxpayer for 60 full months. (The additional days amounting to less than a full month are not taken into account.) The number of complete months from date of issue to date of maturity is 120 (10 years). The fraction $^{60}/_{120}$ multiplied by the discount of $100 is equal to $50, which represents the proportionate part of the original issue discount attributable to the period of ownership by the taxpayer. Accordingly, any part of the gain up to $50 will be treated as ordinary income. Therefore, in this case the entire gain of $40 is treated as ordinary income.

Example 2. Assume the same facts in the preceding example, except that the selling price of the bond is $970. In this case $50 of the gain of $70 is treated as ordinary income and the balance of $20 is treated as long-term capital gain.

Example 3. Assume the same facts as in example (1), except that the selling price of the bond is $800. In this case, the individual has a long-term capital loss of $100.

Example 4. Assume the same facts as in example (1), except that the bond is purchased by the second holder February 1, 1960, for $800. The second holder keeps it to the maturity date (February 1, 1965) when it is redeemed for $1,000. Since that holder has held the bond for 60 full months, he will, upon redemption, have $50 in ordinary income and $150 in long-term capital gain.

(*d*) *Exceptions to the general rule*—(*1*) *In general.* Section 1232(a)(2)(C) provides that section 1232(a)(2) does not apply (i) to obligations the interest on which is excluded from gross income under section 103 (relating to certain government obligations), or (ii) to any holder who purchases an obligation at a premium.

(*2*) *Premium.* For purposes of section 1232, this section, and § 1.1232–3A, *premium* means a purchase price which exceeds the stated redemption price of an obligation at its maturity. For purposes of the preceding sentence, if an obligation is acquired as part of an investment unit consisting of an option, security, or other property and an obligation, the purchase price of the obligation is that portion of the price paid or payable for the unit which is allocable to the obligation. The price paid for the unit shall be allocated to the individual elements of the unit on the basis of their respective fair market values. However, if the fair market value of the option, security, or other property is not readily ascertainable (within the meaning of paragraph (c) of § 1.421–6), then the price paid for the unit shall be allocated in accordance with the rules under paragraph (b)(2)(ii) of this section for allocating the initial offering price of an investment unit to its elements. If, under chapter 1 of the Code, the basis of an obligation in the hands of the holder is

the same, in whole or in part, for the purposes of determining gain or loss from a sale or exchange, as the basis of the obligation in the hands of another person who purchased the obligation at a premium, then the holder shall be considered to have purchased the obligation at a premium. Thus, the donee of an obligation purchased at a premium by the doner will be considered a holder who purchased the obligation at a premium.

(*e*) *Amounts previously includible in income.* Nothing in section 1232(a)(2) shall require the inclusion of any amount previously includible in gross income. Thus, if an amount was previously includible in a taxpayer's income on account of obligations issued at a discount and redeemable for fixed amounts increasing at stated intervals, or, under section 818(b) (relating to accrual of discount on bonds and other evidences of indebtedness held by life insurance companies), such amount is not again includible in the taxpayer's gross income under section 1232(a)(2). For example, amounts includible in gross income by a cash receipts and disbursements method taxpayer who has made an election under section 454 (a) or (c) (relating to accounting rules for certain obligations issued at a discount to which section 1232(a)(3) does not apply) are not includible in gross income under section 1232(a)(2). In the case of a gain which would include, under section 1232(a)(2), an amount considered to be ordinary income and a further amount considered long-term capital gain, any amount to which this paragraph applies is first used to offset the amount considered ordinary income. For example, on January 1, 1955, A purchases a 10-year bond which is redeemable for fixed amounts increasing at stated intervals. At the time of original issue, there was no intention to call the bond before maturity. The purchase price of the bond is $75, which is also the issue price. The stated redemption price at maturity of the bond is $100. A elects to treat the annual increase in the redemption price of the bond as income pursuant to section 454(a). On January 1, 1960, A sells the bond for $90. The total stated increase in the redemption price of the bond which A has reported annually as income for the taxable years 1955 through 1959 is $7. The portion of the original issue discount of $25 attributable to this period is $12.50, computed as follows:

60 (months bond is held by A)/120 (months from date of original issue to redemption date) × $25 (original issue discount)

However, $7, which represents the annual stated increase taken into income, is offset against the amount of $12.50, leaving $5.50 of the gain from the sale to be treated as ordinary income.

(*f*) *Recordkeeping requirements.* In the case of any obligation held by a taxpayer which was issued at an original issue discount after December 31, 1954, the taxpayer shall keep a record of the issue price and issue date upon or with each obligation (if known to or reasonably ascertainable by him). If the obligation held by the taxpayer is an obligation of the United States received from the United States in an exchange upon which gain or loss is not recognized because of section 1037 (a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)), the taxpayer shall keep sufficient records to determine the issue price of such obligation for purposes of applying section 1037(b) and paragraphs (a) and (b) of § 1.1037–1 upon the disposition or redemption of such obligation. The issuer (or in the case of obligations first sold to the public through an underwriter or wholesaler, the underwriter or wholesaler) shall mark the issue price and issue date upon every obligation which is issued at an original issue discount after September 26, 1957, but only if the period between the date of original issue (as defined in paragraph (b)(3) of this section) and the stated maturity date is more than 6 months.

[T.D. 6500, 25 FR 12008, Nov. 26, 1960, as amended by T.D. 6984, 33 FR 19176, Dec. 21, 1968; T.D. 7154, 36 FR 25000, Dec. 28, 1971; 37 FR 527, Jan. 13, 1972; T.D. 7213, 37 FR 21992, Oct. 18, 1972; 37 FR 22863, Oct. 26, 1972; T.D. 7663, 44 FR 76782, Dec. 28, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1232–3A Inclusion as interest of original issue discount on certain obligations issued after May 27, 1969.

(a) *Ratable inclusion as interest*—(1) *General rule.* Under section 1232(a)(3),

the holder of any obligation issued by a corporation after May 27, 1969 (other than an obligation issued by or on behalf of the United States or a foreign country, or a political subdivision of either) shall include as interest in his gross income an amount equal to the ratable monthly portion of original issue discount multiplied by the sum of the number of complete months and any fractional part of a month such holder held the obligation during the taxable year. For increase in basis for amounts included as interest in gross income pursuant to this paragraph, see paragraph (c) of this section. For requirements for reporting original issue discount, see section 6049(a) and the regulations thereunder.

(2) *Ratable monthly portion of original issue discount*—(i) *General rule.* Except when subdivision (ii) of this subparagraph applies, the term *ratable monthly portion of original issue discount* means an amount equal to the original issue discount divided by the sum of the number of complete months (plus any fractional part of a month) beginning on the date of original issue and ending the day before the stated maturity date of such obligation.

(ii) *Reduction for purchase allowance.* With respect to an obligation which has been acquired by purchase (within the meaning of subparagraph (4) of this paragraph), the term *ratable monthly portion of original issue discount* means the lesser of the amount determined under subdivision (i) of this subparagraph or an amount equal to:

(*a*) The excess (if any) of the stated redemption price of the obligation at maturity over its cost to the purchaser divided by

(*b*) The sum of the number of complete months (plus any fractional part of a month) beginning on the date of such purchase and ending the day before the stated maturity date of such obligation.

The amount of the ratable monthly portion within the meaning of this subdivision reflects a purchase allowance provided under section 1232(a)(3)(B) where a purchase is made at a price in excess of the sum of the issue price plus the portion of original issue discount previously includible (regardless of whether included) in the gross income of all previous holders (computed, however, as to such previous holders without regard to any purchase allowance under this subdivision and without regard to whether any previous holder purchased at a premium).

(iii) *Ratable monthly portion upon carryover to new obligation.* In any case in which there is a carryover of original issue discount under paragraph (b)(1)(iv) of §1.1232–3 from an obligation exchanged to an obligation received in such exchange, the ratable monthly portion of original issue discount in respect of the obligation received shall be computed by dividing the amount of original issue discount carried over by the sum of the number of complete months (plus any fractional part of a month) beginning on the date of the exchange and ending the day before the stated maturity date of the obligation received.

(iv) *Cross references.* For definitions of the terms *original issue discount* and *date of original issue*, see subparagraphs (1) and (3) respectively, of §1.1232–3(b). For definition of the term *premium*, see paragraph (d)(2) of §1.1232–3.

(3) *Determination of number of complete months*—(i) *In general.* For purposes of this section:

(*a*) A complete month and a fractional part of a month commence with the date of original issue and the corresponding day of each succeeding calendar month (or the last day of a calendar month in which there is no corresponding day),

(*b*) If an obligation is acquired on any day other than the date a complete month commences, the ratable monthly portion of original issue discount for the complete month in which the acquisition occurs shall be allocated between the transferor and the transferee in accordance with the number of days in such complete month each held the obligation,

(*c*) In determining the allocation under (*b*) of this subdivision, any holder may treat each month as having 30 days,

(*d*) The transferee, and not the transferor, shall be deemed to hold the obligation during the entire day on the date of acquisition, and

(*e*) The obligor will be treated as the transferee on the date of redemption.

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

Example: On February 22, 1970, A acquires an obligation of X Corporation for which February 1, 1970, is the date of original issue. B acquires the obligation on June 16, 1970. A does not choose to treat each month as having 30 days. Thus, A held the obligation for 3¾ months during 1970, i.e., one-fourth of February (7/28 days), March, April, May, one-half of June (15/30 days). The ratable monthly portion of original issue discount for the obligation is multiplied by 3¾ months to determine the amount included in A's gross income for 1970 pursuant to this paragraph.

(4) *Purchase*. For purposes of this section, the term *purchase* means any acquisition (including an acquisition upon original issue) of an obligation to which this section applies, but only if the basis of such obligation is not determined in whole or in part by reference to the adjusted basis of such obligation in the hands of the person from whom it was acquired or under section 1014(a) (relating to property acquired from a decedent).

(b) *Exceptions*—(1) *Binding commitment*. Section 1232(a)(3) shall not apply to any obligation issued pursuant to a written commitment which was binding on May 27, 1969, and at all times thereafter.

(2) *Exception for 1-year obligations*. Section 1232(a)(3) shall not apply to any obligation in respect of which the period between the date of original issue (as defined in paragraph (b)(3) of § 1.1232–3) and the stated maturity date is 1 year or less. In such case, gain on the sale or exchange of such obligation shall be included in gross income as interest to the extent the gain does not exceed an amount equal to the ratable monthly portion of original issue discount multiplied by the sum of the number of complete months and any fractional part of a month such taxpayer held such obligation.

(3) *Purchase at a premium*. Section 1232(a)(3) shall not apply to any holder who purchased the obligation at a premium (within the meaning of paragraph (d)(2) of § 1.1232–3).

(4) *Life insurance companies*. Section 1232(a)(3) shall not apply to any holder which is a life insurance company to which section 818(b) applies. However, ratable inclusion of original issue discount as interest under section 1232(a)(3) is required by an insurance company which is subject to the tax imposed by section 821 or 831.

(c) *Basis adjustment*. The basis of an obligation in the hands of the holder thereof shall be increased by any amount of original issue discount with respect thereto included as interest in his gross income pursuant to paragraph (a) of this section. See section 1232(a)(3)(E). However, the basis of an obligation shall not be increased by any amount that was includible as interest in gross income under paragraph (a) of this section, but was not actually included by the holder in his gross income.

(d) *Examples*. The provisions of paragraphs (a) through (c) of this section may be illustrated by the following examples:

Example 1. On January 1, 1970, A, a calendar-year taxpayer, purchases at original issue, for cash of $7,600, M Corporation's 10-year, 5-percent bond which has a stated redemption price of $10,000. The ratable monthly portion of original issue discount, as determined under section 1232(a)(3) and this section, to be included as interest in A's gross income for each month he holds such bond is $20, computed as follows:

Original issue discount (stated redemption price, $10,000, minus issue price, $7,600)	$2,400	
Divide by: Number of months from date of original issue to stated maturity date	120	months
Ratable monthly portion	$20	

Assume that A holds the bond for all of 1970 and 1971 and includes as interest in his gross income for each such year an amount equal to the ratable monthly portion, $20, multiplied by the number of months he held the bond each such year, 12 months, or $240. Accordingly, on January 1, 1972, A's basis in the bond will have increased under paragraph (c) of this section by the amount so included, $480 (i.e., $240 × 2), from his cost, $7,600, to $8,080. For results if A sells the bond on that date, see examples (1) and (2) of paragraph (a)(2) of § 1.1282–3.

Example 2. Assume the same facts as in example (1). Assume further that on January 1, 1972, A sells the bond to B, a calendar-year taxpayer for $9,040.

Since B purchased the bond, he determines under paragraph (a)(2)(ii) of this section the amount of the ratable monthly portion he must include as interest in his gross income in order to reflect the amount of his purchase allowance (if any). B determines that

his ratable monthly portion is $10, computed as follows:

(1) Stated redemption price at maturity	$10,000	
(2) Minus: B's cost	$9,040	
(3) Excess	$960	
(4) Divide by: Number of months from date of purchase to stated maturity date	96	months
(5) Tentative ratable monthly portion	$10	
(6) Ratable monthly portion as computed in example (1)	$20	

Since line (5) is lower than line (6), B's ratable monthly portion is $10. Accordingly, if B holds the bond for all of 1972, he must include $120 (i.e., ratable monthly portion, $10 × 12 months) as interest in his gross income.

Example 3. (1) Assume the same facts as in example (1). Assume further that on January 1, 1975, A sells the bond to B for $10,150. Under the exception of paragraph (b)(3) of this section, B is not required to include any amount in respect of original issue discount as interest in his gross income since he has purchased the bond at a premium.

(2) On January 1, 1979, B sells the bond to C, a calendar-year taxpayer, for $9,940. Since C is now the holder of the bond (and no exception applies to him), he must include as interest in his gross income the ratable monthly portion of original issue determined under section 1232(a)(3) and this section. Since C purchased the bond he determines under paragraph (a)(2)(ii) of this section the amount of the ratable monthly portion he must include as interest in his gross income in order to reflect the amount of his purchase allowance (if any). C determines that his ratable monthly portion is $5, computed as follows:

(1) Stated redemption price at maturity	$10,000	
(2) Minus: C's cost	$9,940	
(3) Excess	$60	
(4) Divide by: Number of months from date of purchase to stated maturity date	12	months
(5) Tentative ratable monthly portion	$5	
(6) Ratable monthly portion as computed in example (1)	$20	

Since line (5) is lower than line (6), C's ratable monthly portion is $5. Accordingly, if C holds the bond for all of 1979, he must include $60 (i.e., ratable monthly portion, $5, × 12 months) as interest in his gross income. Upon maturity of the bond on January 1, 1980, C will receive $10,000 from M, which under paragraph (c) of this section will equal his adjusted basis (the sum of his cost, $9,940, plus original issue discount included as interest in his gross income, $60).

Example 4. On January 1, 1968, D, a calendar-year taxpayer, purchases at original issue, for cash of $8,000, P Corporation's 20-year, 6 percent bond which has a stated redemption price of $10,000 and which will mature on January 1, 1988. The original issue discount with respect to such bond is $2,000. However, the ratable inclusion rules of section 1232(a)(3) do not apply to D, since the bond was issued by P before May 28, 1969. On January 1, 1973, pursuant to a plan of reorganization as defined in section 368(a)(1)(E), and in which no gain or loss is recognized by D under section 354, D's 20-year bond is exchanged for a 10-year, 6 percent bond which also has a stated redemption price of $10,000 but will mature on January 1, 1983. Under paragraph (b)(1)(iv) of §1.1232–3, the $2,000 of original issue discount is carried over to the new 10-year bond received in such exchange. Since the new bond is an obligation issued after May 27, 1969, D is required to begin ratable inclusion of the $2,000 of discount as interest in his gross income for 1973. The ratable monthly portion of original issue discount, as determined under section 1232(a)(3) to be included as interest in gross income is computed as follows:

Amount of original issue discount carried over	$2,000	
Divide by: Number of complete months beginning on January 1, 1973, and ending on December 31, 1982	120	months
Ratable monthly portion	$16.67	

(e) *Application of section 1232 to certain deposits in financial institutions and similar arrangements*—(1) *In general.* Under paragraph (d) of §1.1232–1, the term *other evidence of indebtedness* includes certificates of deposit, time deposits, bonus plans, and other deposit arrangements with banks, domestic building and loan associations, and similar financial institutions.

(2) *Adjustments where obligation redeemed before maturity*—(i) *In general.* If an obligation described in subparagraph (1) of this paragraph is redeemed for a price less than the stated redemption price at maturity from a taxpayer who acquired the obligation upon original issue, such taxpayer shall be allowed as a deduction, in computing adjusted gross income, the amount of the original issue discount he included in gross income but did not receive (as determined under subdivision (ii) of this subparagraph). The taxpayer's basis of such obligation (determined after any increase in basis for the taxable year under section 1232(a)(3)(E) by the amount of original issue discount included in the holder's gross income

under section 1232(a)(3)) shall be decreased by the amount of such adjustment.

(ii) *Computation*. The amount of the adjustment under subdivision (i) of this subparagraph shall be an amount equal to the excess (if any) of (*a*) the ratable monthly portion of the original issue discount included in the holder's gross income under section 1232(a)(3) for the period he held the obligation, over (*b*) the excess (if any) of the amount received upon the redemption over the issue price. Under paragraph (b)(1)(iii)(*a*) of § 1.1232–3, if any amount based on a fixed rate of simple or compound interest is actually payable or will be treated as constructively received under section 451 and the regulations thereunder at fixed periodic intervals of 1 year or less during the term of the obligation, any such amount payable upon redemption shall not be included in determining the amount received upon such redemption.

(iii) *Partial redemption*. *(a)* In the case of an obligation (other than a single obligation having serial maturity dates), if a portion of the obligation is redeemed prior to the stated maturity date of the entire obligation, the provisions of this subdivision shall be applied and not the provisions of subdivision (ii) of this subparagraph. In such case, the adjusted basis of the unredeemed portion of the obligation on the date of the partial redemption shall be an amount equal to the adjusted basis of the entire obligation on that date minus the amount paid upon the redemption.

(*b*) If the adjusted basis of the unredeemed portion (as computed under (*a*) of this subdivision) is equal to or in excess of the amount to be received for the unredeemed portion at maturity, no gain or loss shall be recognized at the time of the partial redemption but the holder shall be allowed a deduction, in computing adjusted gross income for the taxable year during which such partial redemption occurs, equal to the amount of such excess (if any), and no further original issue discount will be includible in the holder's gross income under section 1232(a)(3) over the remaining term of the unredeemed portion. In such case, the holder shall decrease his basis in the unredeemed portion (as computed under (a) of this subdivision) by the amount of such adjustment.

(*c*) If the adjusted basis of the unredeemed portion (as computed under (*a*) of this subdivision) is less than the redemption price of the unredeemed portion at maturity, a new computation shall be made under paragraph (a) of this section (without regard to the exception for one-year obligations in paragraph (b)(2) of this section) of the ratable monthly portion of original issue discount to be included as interest in the gross income of the holder over the remaining term of the unredeemed portion. For purposes of such computation, the adjusted basis of the unredeemed portion shall be treated as the issue price, the date of the partial redemption shall be treated as the issue date, and the amount to be paid for the unredeemed portion at maturity shall be treated as the stated redemption price.

(3) *Examples*. The application of section 1232 to obligations to which this paragraph applies may be illustrated by the following examples:

Example 1. A is a cash method taxpayer who uses the calendar year as his taxable year. On January 1, 1971, he purchases a certificate of deposit from X Bank, a corporation, for $10,000. The certificate of deposit is not redeemable until December 31, 1975, except in an emergency as defined in, and subject to the qualifications provided by, Regulation Q of the Board of Governors of the Federal Reserve. See 12 CFR 217.4(d). The stated redemption price at maturity is $13,382.26. The terms of the certificate do not expressly refer to any amount as interest. A's certificate of deposit is an obligation to which section 1232 and this paragraph apply. A shall include the ratable portion of original issue discount in gross income for 1971 as determined under section 1232(a)(3). Thus, if A holds the certificate of deposit for the full calendar year 1971, the amount to be included in A's gross income for 1971 is $676.45, that is, 12/60 months, multiplied by the excess of the stated redemption price ($13,382.26) over the issue price ($10,000).

Example 2. Assume the same facts as in example (1), except that the certificate of deposit provides for payment upon redemption at December 31, 1975, of an amount equal to "$10,000, plus 6 percent compound interest from January 1, 1971, to December 31, 1975."

Thus, the total amount payable upon redemption in both example (1) and this example is $13,382.26. The certificate of deposit is an obligation to which section 1232 and this paragraph apply and, since the substance of the deposit arrangement is identical to that contained in example (1), A must include the same amount in gross income.

Example 3. Assume the same facts as in example (1), except that the certificate provides for the payment of interest in the amount of $200 on December 31, of each year and $2,000 plus $10,000 (the original amount) payable upon redemption at December 31, 1975. Thus, if A holds the certificate of deposit for the full calendar year 1971, A must include in his gross income for 1971 the $200 interest payable on December 31, 1971, and $400 of original issue discount, that is, 12/60 months multiplied by the excess of the stated redemption price ($12,000) over the issue price ($10,000).

Example 4. B is a cash method taxpayer who uses the calendar year as his taxable year. On January 1, 1971, B purchases a 4-year savings certificate from the Y Building and Loan Corporation for $4,000, redeemable on December 31, 1974, for $5,000. On December 31, 1973, Y redeems the certificate for $4,660. Under section 1232(a)(3), B included $250 of original issue discount in his gross income for 1971, $250 for 1972, and includes $250 in his gross income for 1973 for a total of $750. Since the excess of (i) the amount received upon the redemption, $4,660, over (ii) the issue price, $4,000, or $660, is lower than the total amount of original issue discount ($750) included in B's gross income for the period he held the certificate by $90, the $90 will be treated under subparagraph (2) of this paragraph as a deduction in computing adjusted gross income, and accordingly, will decrease the basis of his certificate by such amount. B has no gain or loss upon the redemption, as determined in accordance with the following computation:

Adjusted basis January 1, 1973	$4,500
Increase under section 1232(a)(3)(E)	250
Subtotal	4,750
Decrease under subparagraph (b)(2) of this paragraph	90
Basis upon redemption	4,660
Amount realized upon redemption	4,660
Gain or loss	0

Example 5. On January 1, 1971, C, a cash method taxpayer who uses the calendar year as his taxable year, opens a savings account in Z bank with a $10,000 deposit. Under the terms of the account, interest is made available semiannually at 6 percent annual interest, compounded semiannually. Since all of the interest on C's account in Z Bank is made available semiannually, the stated redemption price at maturity under paragraph (b)(1)(iii)(*a*) of § 1.1232–3 equals the issue price, and, therefore, no original issue discount is reportable by C under section 1232(a)(3). However, C must include the sum of $300 (i.e., ½ × 6% × $10,000) plus $309 (i.e., ½ × 6% × $10,300) or $609, of interest made available during 1971 in his gross income for 1971.

Example 6. (i) D is a cash method taxpayer who uses the calendar year as his taxable year. On January 1, 1971, D purchases a $10,000 deferred income certificate from M Bank. Under the terms of the certificate, interest accrues at 6 percent per annum, compounded quarterly. The period of the account is 10 years. In addition, the holder is permitted to withdraw the entire amount of the purchase price at any time (but not interest prior to the expiration of the 10 year term), and upon such a withdrawal of the purchase price, no further interest accrues. If the certificate is held to maturity, the issue price plus accrued interest will aggregate $18,140.18.

(ii) In respect of the certificate, the original issue discount is $8,140.18, determined by subtracting the issue price of the certificate ($10,000) from the stated redemption price at maturity ($18,140.18). Thus, under section 1232(a)(3) the ratable monthly portion of original issue discount is $67.835 (i.e., 1/20 months, multiplied by $8,140.18). Under section 1232(a)(3), D includes $814.02 (i.e., 12 months, multiplied by $67.835) in his gross income for each calendar year the certificate remains outstanding and under section 1232(a)(3)(E) increases his basis by that amount. Thus, on December 31, 1975, D's basis for the certificate is $14,070.10 (i.e., issue price, $10,000, increased by product of $814.02 × 5 years).

(iii) On December 31, 1975, D withdraws the $10,000. Under the terms of the certificate $3,468.55 cannot be withdrawn until December 31, 1980. Under the provisions of subparagraph (2)(iii) of this paragraph, the $10,000 partial redemption shall be treated as follows:

(1) Adjusted basis of obligation at time of partial redemption	$14,070.10
(2) Amount paid upon redemption	10,000.00
(3) Adjusted basis of unredeemed portion (line (1) less line (2))	4,070.10
(4) Amount to be paid for unredeemed portion at maturity (December 31, 1980)	3,468.55
(5) Adjustment in computing adjusted gross income (excess of line (3) over line (4))	601.55

Since the adjusted basis of the unredeemed portion exceeds the amount to be received for the unredeemed portion at maturity, D is allowed a deduction, in computing adjusted gross income, of $601.25 in 1975 and no further original issue discount is includible as interest in his gross income. In addition, D will decrease his basis in the unredeemed portion

by $601.55, the amount of such adjustment, from $4,070.10 to $3,468.55.

Example 7. E is a cash method taxpayer who uses the calendar year as his taxable year. On January 1, 1971, E purchases a $10,000 ''Bonus Savings Certificate'' from N Building and Loan Corporation. Under the terms of the certificate, interest is payable at 5 percent per annum, compounded quarterly, and the period of the account is 3 years. In addition, the certificate provides that if the holder makes no withdrawals of principal or interest during the term of the certificate, a bonus payment equal to 5 percent of the purchase price of the certificate will be paid to the holder of the certificate at maturity. Thus, the amount of the bonus payment is $500 (i.e., 5 percent multiplied by $10,000). Since the 5 percent annual interest is payable quarterly, the amount of such interest is not included in determining the stated redemption price at maturity under paragraph (b)(1)(iii) of §1.1232–3. However, since the bonus payment is only payable at maturity, the amount of such bonus is included as part of the stated redemption price at maturity. Thus, the stated redemption price at maturity equals $10,500 (purchase price, $10,000, plus bonus payment $500). Accordingly, the original issue discount attributable to such certificate equals $500 (stated redemption price at maturity. $10,500, minus issue price, $10,000). Therefore, E must include as interest $166.67 (i.e., 12/36 months, multiplied by the original issue discount, $500) in his gross income for each taxable year he holds the certificate.

(4) *Renewable certificates of deposit*—(i) *In general.* The renewal of a certificate of deposit shall be treated as a purchase of the certificate on the date the renewal period begins regardless of any requirement pursuant to the terms of the certificate that the holder give notice of an intention to renew or not to renew. Thus, for example, in the case of a certificate of deposit for which a renewal period begins after December 31, 1970, such renewal shall be treated as a purchase after such date whether or not the initial period began before such date.

(ii) *Computation.* For purposes of computing the amount of original issue discount to be ratably included as interest in gross income under section 1232(a)(3) in respect of a renewable certificate of deposit for the initial period or any renewal period, the following rules apply:

(*a*) The issue price on the date any renewal period begins is considered to be in the case of a certificate of deposit initially purchased:

(*1*) After December 31, 1970, the adjusted basis of the certificate on the date such period begins,

(*2*) Before January 1, 1971, the amount the adjusted basis would have been on the date such period begins had the holder included all amounts of original issue discount as interest in gross income that would have been includible if section 1232(a)(3) had applied to the certificate from the date of original purchase.

Thus, if under the terms of the certificate, no amount is forfeited upon a failure to renew, then the issue price on the date any renewal period begins is considered to be the amount which would have been received by the holder on such date had it not been renewed.

(*b*) The date of original issue for any renewal period shall be considered to be the date it begins.

(*c*) The date of maturity for the initial period or any renewal period shall be considered to be the date it ends.

(*d*) The stated redemption price at maturity for the initial period or any renewal period shall be considered to be the maximum amount which would be received at the end of any such period, without regard to any reduction resulting from withdrawal prior to maturity or failure to renew at any renewal date.

(iii) *Application of 1-year rule.* For purposes of paragraph (b)(2) of this section (relating to nonapplication of section 1232(a)(3) to any obligation having a term of 1 year or less), the period between the date of original issue (as defined in paragraph (b)(3) of §1.1232–3) of a renewable certificate of deposit and its stated maturity date shall include all renewal periods with respect to which, under the terms of the certificate, the holder may either take action or refrain from taking action which would prevent the actual or constructive receipt of any interest on such certificate until the expiration of any such renewal period whether or not the original date of issue is prior to January 1, 1971.

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

Example: (a) On May 1, 1969, A purchases a 2-year renewable certificate of deposit from M bank, a corporation, for $10,000. Interest will be compounded semiannually at 6 percent on May 1 and November 1. The terms of the certificate provide that such certificate will be automatically renewed on the anniversary date every 2 years if the holder does not notify M of an intention not to renew prior to 60 days before the particular anniversary date. Thus, on May 1, 1971, and May 1, 1973, the certificate may be redeemed for $11,255.09 and $12,667.60, respectively. However, in no event shall the initial period and the renewal periods exceed 10 years. A does not notify M of an intention not to renew by March 1, 1971, and the certificate is automatically renewed for an additional 2-year period on May 1, 1971.

(b) Under subdivision (i) of this subparagraph, the May 1, 1971, renewal shall be treated as the purchase of a certificate of deposit on that date, i.e., after December 31, 1970. Under subdivision (ii) of this subparagraph, the issue price is considered to be $11,255.09 and the date of maturity is considered to be May 1, 1973. Since the stated redemption price at maturity is $12,667.60. A must include $58.85 as interest in gross income for each month he holds the certificate during the renewal period beginning May 1, 1971, computed as follows:

Original issue discount (stated redemption price, $12,667.60, minus issue price, $11,255.09)	$1,412.51
Divided by: Number of months from renewal to maturity date	24 months
Ratable monthly portion	$58.85

(5) *Time deposit open account arrangements*—(i) *In general*. The term *time deposit open account arrangement* means an arrangement with a fixed maturity date where deposits may be made from time to time and ordinarily no interest will be paid or constructively received until such fixed maturity date. All deposits pursuant to such an arrangement constitute parts of a single obligation. The amount of original issue discount to be ratably included as interest in the gross income of the depositor for any taxable year shall be the sum of the amounts separately computed for each deposit. For this purpose, the issue price for a deposit is the amount thereof and the stated redemption price at maturity is computed under paragraph (b)(1)(iii)(*d*) of § 1.1232–3.

(ii) *Obligations redeemed before maturity*. In the event of a partial redemption of a time deposit open account before maturity, the following rules, in addition to subparagraph (2) of this paragraph, shall apply:

(*a*) If, pursuant to the terms of the withdrawal, the amount received by the depositor is determined with reference to the principal amount of a specific deposit and interest earned from the date of such deposit, then such terms shall control for the purpose of determining which deposit was withdrawn.

(*b*) If (*a*) of this subdivision (ii) does not apply, then the withdrawal shall be deemed to be of specific deposits together with interest earned from the date of such deposits, on a first-in, first-out basis.

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

Example 1. (i) F is a cash method taxpayer who uses the calendar year as his taxable year. On December 1, 1970, F enters into a 5-year deposit open account arrangement with M Savings and Loan Corp. The terms of the arrangement provide that F will deposit $100 each month for a period of 5 years, and that interest will be compounded semiannually (on June 1 and December 1) at 6 percent, but will be paid only at maturity. Thus, assuming F makes deposits of $100 on the first of each month beginning with December 1, 1970, the account will have a stated redemption price of $6,998.20 at maturity on December 1, 1975. Since, however, section 1232 applies only to deposits made after December 31, 1970 (see paragraph (d) of § 1.1232–1), the $34.39 of compound interest to be earned on the first deposit of $100 over the term of the arrangement will not be subject to the ratable inclusion rules of section 1232(a)(3). F must include such $34.39 of interest in his gross income on December 1, 1975, the date it is paid.

(ii) For 1971, F must include $44.19 of original issue discount as interest in gross income, to be computed as follows:

(1)	(2)	(3)	(4)	(5)	(6)	(7)
Date of $100 deposit	Months to maturity	Redemption price at maturity	Original issue discount (Col.3 − $100)	Ratable monthly portion (Col.4 ÷ Col.2)	Months on deposit in 1971	1971 original issue discount (Col.5 × Col.6)
1–1–71	59	$133.73	$33.73	$0.5717	12	$6.86
2–1–71	58	133.07	33.07	.5702	11	6.27
3–1–71	57	132.42	32.42	.5688	10	5.69

(1)	(2)	(3)	(4)	(5)	(6)	(7)
Date of $100 deposit	Months to maturity	Redemption price at maturity	Original issue discount (Col.3 − $100)	Ratable monthly portion (Col.4 ÷ Col.2)	Months on deposit in 1971	1971 original issue discount (Col.5 × Col.6)
4–1–71	56	131.77	31.77	.5673	9	5.11
5–1–71	55	131.12	31.12	.5658	8	4.53
6–1–71	54	130.48	30.48	.5644	7	3.95
7–1–71	53	129.84	29.84	.5630	6	3.38
8–1–71	52	129.20	29.20	.5615	5	2.81
9–1–71	51	128.56	28.56	.5600	4	2.24
10–1–71	50	127.93	27.93	.5586	3	1.68
11–1–71	49	127.30	27.30	.5571	2	1.11
12–1–71	48	126.68	26.68	.5558	1	0.56
Total original issue discount to be included as interest in F's gross income for 1971						44.19

Example 2. (i) G is a cash method taxpayer who uses the calendar year as his taxable year. On February 1, 1971, G enters into a 4-year deposit open account arrangement with T Bank, a corporation. The terms of the deposit arrangement provide that G may deposit any amount from time to time in multiples of $50 for a period of 4 years. The terms also provide that G may not redeem any amount until February 1, 1975, except in an emergency as defined in, and subject to the qualifications provided by, Regulation Q of the Board of Governors of the Federal Reserve System. See 12 CFR 217.4(d). Interest will be compounded semiannually (on February 1 and August 1) at 6 percent, providing there is no redemption prior to February 1, 1975. However, if there is a redemption prior to such date, interest will be compounded semiannually at 5½ percent.

(ii) The schedule of deposits made by G pursuant to the arrangement, and computation of ratable monthly portion for each deposit, is set forth in the table below:

(1)	(2)	(3)	(4)	(5)	(6)
Date of deposit	Months to maturity	Amount of deposit	Redemption price at maturity	Original issue discount (Col.4 − Col.3)	Ratable monthly portion (Col.5 ÷ Col.2)
2–1–71	48	100	$126.68	$26.68	0.5558
6–1–71	44	200	248.42	48.42	1.1005
12–1–71	38	500	602.95	102.95	2.7092
2–1–72	36	800	955.24	155.24	4.3122
3–1–72	35	800	950.56	150.56	4.3017
7–1–72	31	600	699.00	99.00	3.1935
8–1–72	30	250	289.82	39.82	1.3273

(iii) With respect to amounts on deposit pursuant to the arrangement, the amounts of original issue discount G must include as interest in his gross income for 1971 and 1972 are computed in the table below:

(1)	(2)	(3)	(4)	(5)	(6)
Date of deposit	Ratable monthly portion	Months on deposit in 1971	1971 original issue discount (Col.2 × Col.3)	Months on deposit in 1972	1972 original issue discount (Col.2 × Col.5)
2–1–71	$0.5558	11	$6.11	12	$6.67
6–1–71	1.1005	7	7.70	12	13.21
12–1–71	2.7092	1	2.71	12	32.51
2–1–72	4.3122			11	47.43
3–1–72	4.3017			10	43.02
7–1–72	3.1935			6	19.16
8–1–72	1.3273			5	6.64
Total original issue discount includible as interest in gross income for taxable year			16.52		168.64

(6) *Certain contingent interest arrangement*—(i) *In general*. If under the terms of a deposit arrangement:

(*a*) The holder cannot receive payment of any interest or constructively receive any interest prior to a fixed maturity date,

(*b*) Interest is earned at a guaranteed minimum rate of compound interest,

(*c*) Additional contingent interest may be earned for any year at a rate not to exceed one percentage point above such guaranteed minimum rate, and

(*d*) Any additional contingent interest is credited at least annually to the depositor's account,

Then any contingent interest credited to the depositor shall be treated as creating a separate obligation subject to the rules of subdivision (ii) of this subparagraph.

(ii) *Computation*. For purposes of computing the original issue discount to be included as interest in the depositor's gross income under section 1232(a)(3) with respect to such separate obligation:

(*a*) The issue price shall be zero,

(*b*) The date of original issue shall be the date on which the contingent interest is credited to the depositor's account and begins to earn interest,

(*c*) The date of maturity shall be the fixed maturity date of the deposit, and

(*d*) The stated redemption price at maturity is the sum of the amount of such contingent interest plus any interest to be earned thereon at the guaranteed minimum rate of compound interest between such dates of original issue and maturity.

(7) *Contingent interest arrangements other than those described in subparagraph (6)*—(i) *In general*. If under the terms of a deposit arrangement, contingent interest may be earned and credited to a depositor's account, but is neither actually or constructively received before a fixed maturity date nor treated under subparagraph (6)(i) of this paragraph as creating a separate obligation, then the redemption price shall include the amount which would be credited to such account assuming the issuer, during the term of such account, credits contingent interest at the greater of the rate:

(*a*) Last credited on a similar account, or

(*b*) Equal to the average rate credited for the preceding 5 calendar years on a similar account.

(ii) *Adjustments for additional interest*. The rate taken into account under this subparagraph in computing the redemption price shall be treated as the guaranteed minimum rate for purposes of applying subparagraph (6) of this paragraph in the event the rate at which contingent interest is actually credited to the depositor's account exceeds such rate previously taken into account. If for any period the actual rate at which contingent interest is credited to the account exceeds by more than 1 percentage point the rate for the previous period taken into account under this subparagraph in computing the redemption price, a new computation shall be made to determine the ratable monthly portion of original issue discount to be included as interest in the gross income of the depositor over the remaining term of the account. For purposes of such computation, the date that interest is first so credited to the account shall be treated as the issue date, the adjusted basis of the account on such date shall be the issue price, and the redemption price shall equal the amount actually on deposit in the account on such date plus the amount which would be credited to such account assuming the issuer, during the remaining term of such account, continues to credit contingent interest at the new rate.

(iii) *Adjustment for reduced interest*. If for any period the actual rate of interest at which contingent interest is credited to the depositor's account is less than the rate for the previous period taken into account under this subparagraph in computing the redemption price, the difference between the amount of interest which would have been credited to the account at the rate for such previous period and the amount actually credited shall be allowed as a deduction against the amount of original issue discount with respect to such account required to be included in the gross income of the depositor. If an account is redeemed for a price less than the adjusted basis of the account, the depositor shall be allowed

as a deduction, in computing adjusted gross income, the amount of the original issue discount he included in gross income but did not receive.

(f) *Application of section 1232(a)(3) to face-amount certificates*—(1) *In general.* Under paragraph (c)(3) of § 1.1232–1, the provisions of section 1232(a)(3) and this section apply in the case of a face-amount certificate issued after December 31, 1975 (other than such a certificate issued pursuant to a written commitment which was binding on such date and at all times thereafter).

(2) *Relationship with paragraph (e) of this section.* Determinations with regard to the inclusion as interest of original issue discount on, and certain adjustments with respect to, face-amount certificates to which this section applies shall be made in a manner consistent with the rules of paragraph (e) of this section (relating to the application of section 1232 to certain deposits in financial institutions and similar arrangements). Thus, for example, if a face-amount certificate is redeemed before maturity, the holder shall be allowed a deduction in computing adjusted gross income computed in a manner consistent with the rules of paragraph (e)(2) of this section. For a further example, if under the terms of a face-amount certificate, the issuer may grant additional credits to be paid at a fixed maturity date, computations with respect to such additional credits shall be made in a manner consistent with the rules of paragraphs (e) (6) and (7) of this section (as applicable) relating to contingent interest arrangements.

[T.D. 7154, 36 FR 25005, Dec. 28, 1971; 37 FR 527, Jan. 13, 1972, as amended by T.D. 7213, 37 FR 21993, Oct. 18, 1972; 37 FR 22863, Oct. 26, 1972; T.D. 7311, 39 FR 11880, Apr. 1, 1974; T.D. 7365, 40 FR 27936, July 2, 1975]

§ 1.1233–1 Gains and losses from short sales.

(a) *General.* (1) For income tax purposes, a short sale is not deemed to be consummated until delivery of property to close the short sale. Whether the recognized gain or loss from a short sale is capital gain or loss or ordinary gain or loss depends upon whether the property so delivered constitutes a capital asset in the hands of the taxpayer.

(2) Thus, if a dealer in securities makes a short sale of X Corporation stock, ordinary gain or loss results on closing of the short sale if the stock used to close the short sale was stock which he held primarily for sale to customers in the ordinary course of his trade or business. If the stock used to close the short sale was a capital asset in his hands, or if the taxpayer in this example was not a dealer, a capital gain or loss would result.

(3) Generally, the period for which a taxpayer holds property delivered to close a short sale determines whether long-term or short-term capital gain or loss results.

(4) Thus, if a taxpayer makes a short sale of shares of stock and covers the short sale by purchasing and delivering shares which he held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), the recognized gain or loss would be considered short-term capital gain or loss. If the short sale is made through a broker and the broker borrows property to make a delivery, the short sale is not deemed to be consummated until the obligation of the seller created by the short sale is finally discharged by delivery of property to the broker to replace the property borrowed by the broker.

(5) For rules for determining the date of sale for purposes of applying under section 1091 the 61-day period applicable to a short sale of stock or securities at a loss, see paragraph (g) of § 1.1091–1.

(b) *Hedging transactions.* Under section 1233(g), the provisions of section 1233 and this section shall not apply to any bona fide hedging transaction in commodity futures entered into by flour millers, producers of cloth, operators of grain elevators, etc., for the purpose of their business. Gain or loss from a short sale of commodity futures which does not qualify as a hedging transaction shall be considered gain or loss from the sale or exchange of a capital asset if the commodity future used to close the short sale constitutes a capital asset in the hands of the taxpayer as explained in paragraph (a) of this section.

(c) *Special short sales*—(1) *General.* Section 1233 provides rules as to the

tax consequences of a short sale of property if gain or loss from the short sale is considered as gain or loss from the sale or exchange of a capital asset under section 1233(a) and paragraph (a) of this section and if, at the time of the short sale or on or before the date of the closing of the short sale, the taxpayer holds property substantially identical to that sold short. The term *property* is defined for purposes of such rules to include only stocks and securities (including stocks and securities dealt with on a *when issued* basis) and commodity futures, which are capital assets in the hands of the taxpayer. Certain restrictions on the application of the section to commodity futures are provided in section 1233(e) and paragraph (d)(2) of this section. Section 1233(f) contains special provisions governing the operation of rule (2) in subparagraph (2) of this paragraph in the case of a purchase and short sale of stock (as defined in subparagraph (3) qualifying as an arbitrage operation. See paragraph (f) of this section for detailed rules relating to arbitrage operations in stocks and securities.

(2) *Treatment of special short sales.* The first two rules, which are set forth in section 1233(b), are applicable whenever property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) (determined without regard to rule (2), contained in this subparagraph, relating to the holding period) or is acquired by him after the short sale and on or before the date of the closing thereof. These rules are:

Rule (1). Any gain upon the closing of such short sale shall be considered as a gain upon the sale or exchange of a capital asset held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) (notwithstanding the period of time any property used to close such short sale has been held); and

Rule (2). The holding period of such substantially identical property shall be considered to begin (notwithstanding the provisions of section 1223) on the date of the closing of such short sale or on the date of a sale, gift, or other disposition of such property, whichever date occurs first.

(3) *Options to sell.* For the purpose of rule (1) and rule (2) in subparagraph (2) of this paragraph, the acquisition of an option to sell property at a fixed price shall be considered a short sale, and the exercise or failure to exercise such option shall be considered as a closing of such short sale, except that any option to sell property at a fixed price acquired on or after August 17, 1954 (the day after enactment of the Internal Revenue Code of 1954), shall not be considered a short sale and the exercise or failure to exercise such option shall not be considered as the closing of a short sale provided that the option and property identified as intended to be used in its exercise are acquired on the same date. This exception shall not apply, if the option is exercised, unless it is exercised by the sale of the property so identified. In the case of any option not exercised which falls within this exception, the cost of such option shall be added to the basis of the property with which such option is identified. If the option itself does not specifically identify the property intended to be used in exercising the option, then the identification of such property shall be made by appropriate entries in the taxpayer's records within 15 days after the date such property is acquired or before November 17, 1956, whichever expiration date later occurs.

(4) *Treatment of losses.* The third rule, which is set forth in section 1233(d), is applicable whenever property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). This rule is:

Rule (3). Any loss upon the closing of such short sale shall be considered as a loss upon the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), not withstanding the period of time any property used to close such short sale has been held. For the purpose of this rule, the acquisition of an option to sell property at a fixed price is not considered a short sale, and the exercise or failure to exercise such option is not considered as a closing of a short sale.

(5) *Application of rules.* Rules (1) and (3) contained in subparagraphs (2) and (4) of this paragraph do not apply to

the gain or loss attributable to so much of the property sold short as exceeds in quantity the substantially identical property referred to in section 1233 (b) and (d), respectively. Except as otherwise provided in section 1233(f), rule (2) in subparagraph (2) of this paragraph applies to the substantially identical property referred to in section 1233(b) in the order of the dates of the acquisition of such property, but only to so much of such property as does not exceed the quantity sold short. If property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), or is acquired by him after the short sale and on or before the date of the closing thereof, and if property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), all three rules are applicable.

(6) *Examples*. The following examples illustrate the application of these rules to short sales of stock in the case of a taxpayer who makes his return on the basis of the calendar year:

Example 1. A buys 100 shares of X stock at $10 per share on February 1, 1955, sells short 100 shares of X stock at $16 per share on July 1, 1955, and closes the short sale on August 2, 1955, by delivering the 100 shares of X stock purchased on February 1, 1955, to the lender of the stock used to effect the short sale. Since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the gain of $600 realized upon the closing of the short sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain.

Example 2. A buys 100 shares of X stock at $10 per share on February 1, 1955, sells short 100 shares of X stock at $16 per share on July 1, 1955, closes the short sale on August 1, 1955, with 100 shares of X stock purchased on that date at $18 per share, and on August 2, 1955, sells at $18 per share the 100 shares of X stock purchased on February 1, 1955. The $200 loss sustained upon the closing of the short sale is a short-term capital loss to which section 1233(d) has no application. By application of rule (2) in subparagraph (2) of this paragraph, however, the holding period of the 100 shares of X stock purchased on February 1, 1955, and sold on August 2, 1955 is considered to begin on August 1, 1955, the date of the closing of the short sale. The $800 gain realized upon the sale of such stock is, therefore, a short-term capital gain.

Example 3. A buys 100 shares of X stock at $10 per share on February 1, 1955, sells short 100 shares of X stock at $16 per share on September 1, 1955, sells on October 1, 1955, at $18 per share the 100 shares of X stock purchased on February 1, 1955, and closes the short sale on October 1, 1955, with 100 shares of X stock purchased on that date at $18 per share. The $800 gain realized upon the sale of the 100 shares of X stock purchased on February 1, 1955, is a long-term capital gain to which section 1233(b) has no application. Since A had held 100 shares of X stock on the date of the short sale for more than 6 months, the $200 loss sustained upon the closing of the short sale is, by application of rule (3) in subparagraph (4) of this paragraph, a long-term capital loss. If, instead of purchasing 100 shares of X stock on October 1, 1955, A closed the short sale with the 100 shares of stock purchased on February 1, 1955, the $600 gain realized on the closing of the short sale would be a long-term capital gain to which section 1233(b) has no application.

Example 4. A sells short 100 shares of X stock at $16 per share on February 1, 1955. He buys 250 shares of X stock on March 1, 1955, at $10 per share and holds the latter stock until September 2, 1955 (more than 6 months), at which time, 100 shares of the 250 shares of X stock are delivered to close the short sale made on February 1, 1955. Since substantially identical property was acquired by A after the short sale and before it was closed, the $600 gain realized on the closing of the short sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain. The holding period of the remaining 150 shares of X stock is not affected by section 1233 since this amount of the substantially identical property exceeds the quantity of the property sold short.

Example 5. A buys 100 shares of X stock at $10 per share on February 1, 1955, buys an additional 100 shares of X stock at $20 per share on July 1, 1955, sells short 100 shares of X stock at $30 per share on September 1, 1955, and closes the short sale on February 1, 1956, by delivering the 100 shares of X stock purchased on February 1, 1955, to the lender of the stock used to effect the short sale. Since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the gain of $2,000 realized upon the closing of the short sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain and the holding period of the 100 shares of X stock purchased on July 1, 1955, is considered, by application of rule (2) in subparagraph (2) of this paragraph to begin on February 1, 1956, the date of the closing of the short sale. If, however, the 100 shares of X stock purchased on July 1, 1955,

had been used by A to close the short sale, then, since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the gain of $1,000 realized upon the closing of the short sale would be, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain, but the holding period of the 100 shares of X stock purchased on February 1, 1955, would not be affected by section 1233. If, on the other hand, A purchased an additional 100 shares of X stock at $40 per share on February 1, 1956, and used such shares to close the short sale at that time, then, since 100 shares of X stock had been held by A on the date of the short sale for more than 6 months, the loss of $1,000 sustained upon the closing of the short sale would be, by application of rule (3) in subparagraph (4) of this paragraph, a long-term capital loss, and since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the holding period of the 100 shares of X stock purchased on July 1, 1955, would be considered, by application of rule (2) in subparagraph (2) of this paragraph, to begin on February 1, 1956, but the holding period of the 100 shares of X stock purchased on February 1, 1955, would not be affected by section 1233.

Example 6. A buys 100 shares of X preferred stock at $10 per share on February 1, 1955. On July 1, 1955, he enters into a contract to sell 100 shares of XY common stock at $16 per share when, as, and if issued pursuant to a particular plan of reorganization. On August 2, 1955, he receives 100 shares of XY common stock in exchange for the 100 shares of X preferred stock purchased on February 1, 1955, and delivers such common shares in performance of his July 1, 1955, contract. Assume that the exchange of the X preferred stock for the XY common stock is a tax-free exchange pursuant to section 354(a)(1), and that on the basis of all of the facts and circumstances existing on July 1, 1955, the *when issued* XY common stock is substantially identical to the X preferred stock. Since 100 shares of substantially identical property had been held by A for not more than 6 months on the date of entering into the July 1, 1955, contract of sale, the gain of $600 realized upon the closing of the contract of sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain.

(d) *Other rules for the application of section 1233*—(1) *Substantially identical property*. The term *substantially identical property* is to be applied according to the facts and circumstances in each case. In general, as applied to stocks or securities, the term has the same meaning as the term *substantially identical stock or securities* used in section 1091, relating to wash sales of stocks or securities. For certain restrictions on the term as applied to commodity futures see subparagraph (2) of this paragraph. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. In certain situations they may be substantially identical; for example, in the case of a reorganization the facts and circumstances may be such that the stocks and securities of predecessor and successor corporations are substantially identical property. Similarly, bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, in certain situations, as, for example, where the preferred stock or bonds are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may be such as to make such bonds or preferred stock and the common stock substantially identical property. Similarly, depending on the facts and circumstances, the term may apply to the stocks and securities to be received in a corporate reorganization or recapitalization, traded in on a when issued basis, as compared with the stocks or securities to be exchanged in such reorganization or recapitalization.

(2) *Commodity futures*. (i) As provided in section 1233(e)(2)(B), in the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in one calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month. For example, commodity futures in May wheat and July wheat are not considered, for the purpose of section 1233, substantially identical property. Similarly, futures in different commodities which are not generally through custom of the trade used as hedges for each other (such as corn and wheat, for example) are not considered substantially identical property. If commodity futures are otherwise substantially identical property, the mere fact that they were procured through different

brokers will not remove them from the scope of the term *substantially identical property*. Commodity futures procured on different markets may come within the term *substantially identical property* depending upon the facts and circumstances in the case, with the historical similarity in the price movements in the two markets as the primary factor to be considered.

(ii) Section 1233(e)(3), relating to so-called *arbitrage* transactions in commodity futures, provides that where a taxpayer enters into two commodity futures transactions on the same day, one requiring delivery by him in one market and the other requiring delivery to him of the same (or substantially identical) commodity in the same calendar month in a different market, and the taxpayer subsequently closes both such transactions on the same day, section 1233 shall have no application to so much of the commodity involved in either such transaction as does not exceed in quantity the commodity involved in the other. Section 1233(f), relating to arbitrage operations in stocks or securities, has no application to arbitrage transactions in commodity futures.

(iii) The following example indicates the application of section 1233 to a commodity futures transaction:

Example: A, who makes his return on the basis of the calendar year, on February 1, 1955, enters into a contract through broker X to purchase 10,000 bushels of December wheat on the Chicago market at $2 per bushel. On July 1, 1955, he enters into a contract through broker Y to sell 10,000 bushels of December wheat on the Chicago market at $2.25 per bushel. On August 2, 1955, he closes both transactions at $2.50 per bushel. The $2,500 loss sustained on the closing of the short sale is a short-term capital loss to which section 1233(d) has no application. By application of rule (2) in paragraph (c)(2) of this section, however, the holding period of the futures contract entered into on February 1, 1955, is considered to begin on August 2, 1955, the date of the closing of the short sale. The $5,000 gain realized upon the closing of such contract is, therefore, a short-term capital gain.

(3) *Husband and wife.* Section 1233(e)(2)(C) provides that, in the case of a short sale of property by an individual, the term *taxpayer* in the application of subsections (b), (d), and (e) shall be read as *taxpayer or his spouse*. Thus, if the spouse of a taxpayer holds or acquires property substantially identical to that sold short by the taxpayer, and other conditions of subsections (b), (d), and (e) are met, then the rules set forth therein are applicable to the same extent as if the taxpayer held or acquired the substantially identical property. For this purpose, an individual who is legally separated from the taxpayer under a decree of divorce or of separate maintenance shall not be considered as the spouse of the taxpayer.

(e) *Special rule for short sales by dealers in securities under certain circumstances.* In the case of a short sale of stock (as defined in subparagraph (3) of this paragraph) after December 31, 1957, by a dealer in securities, section 1233(e)(4)(A) provides that the holding period of substantially identical stock which he has held as an investment for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) shall be determined in accordance with section 1233(b)(2) unless such short sale is closed within 20 days of the date on which it was made. See rule (2) in paragraph (c)(2) of this section for the purpose of determining the holding period of such substantially identical stock. In addition, section 1233(e)(4)(B) provides that for the purpose of the special rule of section 1233(e)(4)(A), the acquisition of an option to sell property at a fixed price shall be considered a short sale, and the exercise or failure to exercise such option shall be considered a closing of such short sale. For purposes of this paragraph:

(1) Whether or not a taxpayer is a *dealer in securities* shall be determined in accordance with the meaning of the term for purposes of section 1236;

(2) Whether or not stock is *substantially identical* with other property shall be determined in accordance with the provisions of paragraph (d)(1) of this section; and

(3) The term *stock* means:

(i) Any share or certificate of stock,

(ii) Any bond or other evidence of indebtedness which is convertible into a share or certificate of stock, and

(iii) Any evidence of an interest in, or right to subscribe to or purchase, any

of the items described in subdivision (i) or (ii) of this subparagraph.

(f) *Arbitrage operations in stocks and securities and holding periods*—(1) *General rule.* (i) In the case of a short sale entered into as part of an arbitrage operation, rule (2) of paragraph (c)(2) of this section shall apply first to substantially identical property acquired for arbitrage operations and held by the taxpayer at the close of business on the day of the short sale. The holding period of substantially identical property not acquired for arbitrage operations shall be affected only to the extent that the amount of property sold short exceeds the amount of substantially identical property acquired for arbitrage operations and held by the tapayer at the close of business on the day of the short sale.

(ii) If the substantially identical property acquired for arbitrage operations is disposed of without closing the short sale so that a net short position in assets acquired for arbitrage operations is created, a short sale in the amount of such net short position will be deemed to have been made on the day such net short position is created. Rule (2) of paragraph (c)(2) of this section will then apply to substantially identical property not acquired for arbitrage operations to the same extent as if the taxpayer, on the day such net short position is created, sold short an amount equal to the amount of the net short position in a transaction not entered into as part of an arbitrage operation.

(iii) The following examples illustrate the application of rule (2) of paragraph (c)(2) of this section to arbitrage operations:

Example 1. On August 13, 1957, A buys 100 bonds of X Corporation for purposes other than arbitrage operations. The bonds are convertible at the option of the bondholders into common stock of X Corporation on the basis of one bond for one share of stock. On November 1, 1957, A sells short 100 shares of common stock of X Corporation in a transaction identified and intended to be part of an arbitrage operation and on the same day buys another 100 bonds of X Corporation in a transaction identified and intended to be part of the same arbitrage operation. The bonds acquired on both August 13, 1957, and November 1, 1957, are, on the basis of all the facts and circumstances, substantially identical to the common stock of X Corporation. On December 1, 1957, A closes the short sale with 100 shares of common stock of X Corporation acquired on that day. The holding period of the bonds acquired on November 1, by application of rule (2) of paragraph (c)(2) of this section, will be deemed to begin on December 1 and the holding period of the bonds acquired on August 13 will be unaffected. If, instead of purchasing the 100 shares of common stock of X Corporation on December 1, 1957, A had converted the bonds acquired on November 1 into common stock and, on December 1, 1957, used the stock so acquired to close the short sale, rule (2) of paragraph (c)(2) of this section would similarly have no effect on the holding period of the bonds acquired on August 13.

Example 2. Assume the same facts as in example (1), except that A, on December 1, sells the bonds acquired on November 1 (or converts such bonds into common stock and sells the stock), but does not close the short sale. The sale of the bonds (or stock) creates a net short position in assets acquired for arbitrage operations which is deemed to be a short sale made on December 1. Accordingly, the holding period of the bonds acquired on August 13 will, by application of rule (2) of paragraph (c)(2) of this section, begin on the date such short sale is closed or on the date of sale, gift, or other disposition of such bonds, whichever date occurs first.

(2) *Right to receive or acquire property.* (i) For purposes of section 1233(f) (1) and (2) and subparagraph (1) of this paragraph, a taxpayer will be deemed to hold substantially identical property acquired for arbitrage operations at the close of any business day if, by virtue of the ownership of other property acquired for arbitrage operations (whether or not substantially identical) or because of any contract entered into by the taxpayer in an arbitrage operation, he then has the right to receive or acquire such substantially identical property.

(ii) The application of section 1233(f)(3) and subdivision (i) of this subparagraph may be illustrated by the following example:

Example: A acquires on August 13, 1957, 100 shares of common stock of X Corporation for purposes other than arbitrage operations. On November 1, A sells short, in a transaction identified and intended to be part of an arbitrage operation, 100 shares of X common stock. On the same day, in a transaction also identified and intended to be part of the same arbitrage operation, A contracts to purchase 100 shares of preferred stock of X. The preferred stock of X may be converted into common stock of X on the basis of one

share of preferred stock for one share of common stock. The preferred stock is not actually delivered to A until November 3. Since A has contracted before the close of business on the date of the short sale, as part of an arbitrage operation, to purchase property by virtue of which he has the right to receive or acquire substantially identical property to that sold short, he will be deemed, for purposes of section 1233(f) (1) and (2), to hold such substantially identical property at the close of business on the date of the short sale. For purposes of this subparagraph, it is immaterial whether, on the basis of all the facts and circumstances, the preferred stock of X is substantially identical to the common stock of X. The short sale on November 1 does not affect the holding period of the 100 shares of X Corporation common stock purchased on August 13, 1957. Because of the operation of rule (2) of paragraph (c)(2) of this section, the holding period of the preferred stock acquired as the result of A's contract to purchase it as part of an arbitrage operation (or the common stock which A acquires by conversion of such preferred stock into common stock) will not begin until the short sale entered into in the arbitrage operation is closed.

(3) *Definition of arbitrage operations.* For the purpose of section 1233(f), arbitrage operations are transactions involving the purchase and sale of property entered into for the purpose of profiting from a current difference between the price of the property purchased and the price of the property sold. Assets acquired for arbitrage operations include only stocks and securities and rights to acquire stocks and securities. The property purchased may be either identical to the property sold or, if not so identical, such that its acquisition will entitle the taxpayer to acquire property which is so identical. Thus, the purchase of bonds or preferred stock convertible, at the holder's option, into common stock and the short sale of the common stock which may be acquired therefor, or the purchase of stock rights and the short sale of the stock to be acquired on the exercise of such rights, may qualify as arbitrage operations. A transaction will qualify as an arbitrage operation under section 1233(f) only if the taxpayer properly identifies the transaction as an arbitrage operation on his records as soon as he is able to do so. Such identification must ordinarily be entered in the taxpayer's records on the day of the transaction. Property acquired in a transaction properly identified as part of an arbitrage operation is the only property which will be deemed acquired for an arbitrage operation. The provisions of section 1233(f) and this paragraph shall continue to apply to property acquired in a transaction properly identified as an arbitrage operation although, because of subsequent events, e.g., a change in the value of bonds so acquired or of stock into which such bonds may be converted, the taxpayer sells such property outright rather than using it to complete the arbitrage operation.

(4) *Effective date of section 1233(f).* Section 1233(f), relating to arbitrage operations involving short sales of property, is effective only with respect to taxable years ending after August 12, 1955, and only with respect to short sales made after such date.

[T.D. 6500, 25 FR 12011, Nov. 26, 1960, as amended by T.D. 6494, 25 FR 9372, Sept. 30, 1960; T.D. 6926, 32 FR 11468, Aug. 9, 1967; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1233–2 Hedging transactions.

The character of gain or loss on a short sale that is (or is identified as being) part of a hedging transaction is determined under the rules of § 1.1221–2.

[T.D. 8555, 59 FR 36367, July 18, 1994]

§ 1.1234–1 Options to buy or sell.

(a) *Sale or exchange*—(1) *Capital assets.* Gain or loss from the sale or exchange of an option (or privilege) to buy or sell property which is (or if acquired would be) a capital asset in the hands of the taxpayer holding the option is considered as gain or loss from the sale or exchange of a capital asset (unless, under the provisions of subparagraph (2) of this paragraph, the gain or loss is subject to the provisions of section 1231). The period for which the taxpayer has held the option determines whether the capital gain or loss is short-term or long-term.

(2) *Section 1231 transactions.* Gain or loss from the sale or exchange of an option to buy or sell property is considered a gain or loss subject to the provisions of section 1231 if, had the sale or exchange been of the property subject to the option, held by the taxpayer for the length of time he held the option,

the sale or exchange would have been subject to the provisions of section 1231.

(3) *Other property*. Gain or loss from the sale or exchange of an option to buy or sell property which is not (or if acquired would not be) a capital asset in the hands of the taxpayer holding the option is considered ordinary income or loss (unless under the provisions of subparagraph (2) of this paragraph, the gain or loss is subject to the provisions of section 1231).

(b) *Failure to exercise option*. If the holder of an option to buy or sell property incurs a loss on failure to exercise the option, the option is deemed to have been sold or exchanged on the date that it expired. Any such loss to the holder of an option is treated under the general rule provided in paragraph (a) of this section. In general, any gain to the grantor of an option arising from the failure of the holder to exercise it, and any gain or loss realized by the grantor of an option as a result of a closing transaction, such as repurchasing the option from the holder, is considered ordinary income or loss. However, for the treatment of gain or loss from a closing transaction with respect to or gain on the lapse of an option granted in stock, securities, commodities or commodity futures, see section 1234(b) and § 1.1234–3. For special rules for grantors of straddles applicable to certain options granted on or before September 1, 1976, see § 1.1234–2.

(c) *Certain options to sell property at a fixed price*. Section 1234 does not apply to a loss on the failure to exercise an option to sell property at a fixed price which is acquired on the same day on which the property identified as intended to be used in exercising the option is acquired. Such a loss is not recognized, but the cost of the option is added to the basis of the property with which it is identified. See section 1233(c) and the regulations thereunder.

(d) *Dealers in options to buy or sell*. Any gain or loss realized by a dealer in options from the sale or exchange or an option to buy or sell property is considered ordinary income or loss under paragraph (a)(3) of this section. A dealer in options to buy or sell property is considered a dealer in the property subject to the option.

(e) *Other exceptions*. Section 1234 does not apply to gain resulting from the sale or exchange of an option:

(1) To the extent that the gain is in the nature of compensation (see sections 61 and 421, and the regulations thereunder, relating to employee stock options);

(2) If the option is treated as section 306 stock (see section 306 and the regulations thereunder, relating to dispositions of certain stock); or

(3) To the extent that the gain is a distribution of earnings or profits taxable as a dividend (see section 301 and the regulations thereunder, relating to distributions of property).

(4) Acquired by the taxpayer before March 1, 1954, if in the hands of the taxpayer such option is a capital asset (whether or not the property to which the option relates is, or would be if acquired by the taxpayer, a capital asset in the hands of the taxpayer).

(f) *Limitations on effect of section*. Losses to which section 1234 applies are subject to the limitations on losses under sections 165(c) and 1211 when applicable. Section 1234 does not permit the deduction of any loss which is disallowed under any other provision of law. In addition, section 1234 does not apply to an option to lease property, but does apply to an option to buy or sell a lease. Thus, an option to obtain all the right, title, and interest of a lessee in leased property is subject to the provisions of section 1234, but an option to obtain a sublease from the lessee is not. Furthermore, if section 1234 applies to an option to buy or sell a lease, it is the character the lease itself, if acquired, would have in the hands of the taxpayer, and not the character of the property leased, which determines the treatment of gain or loss experienced by the taxpayer with respect to such an option.

(g) *Examples*. The rules set forth in this section may be illustrated by the following examples:

Example 1. A taxpayer is considering buying a new house for his residence and acquires an option to buy a certain house at a fixed price. Although the property goes up in value, the taxpayer decides he does not want

the house for his residence and sells the option for more than he paid for it. The gain which taxpayer realized is a capital gain since the property, if acquired, would have been a capital asset in his hands.

Example 2. Assume the same facts as in example (1), except that the property goes down in value, and the taxpayer decides not to purchase the house. He sells the option at a loss. While this is a capital loss under section 1234, it is not a deductible loss because of the provisions of section 165(c).

Example 3. A dealer in industrial property acquires an option to buy an industrial site and fails to exercise the option. The loss is an ordinary loss since he would have held the property for sale to customers in the ordinary course of his trade or business if he had acquired it.

[T.D. 6500, 25 FR 12013, Nov. 26, 1960, as amended by T.D. 7652, 44 FR 62282, Oct. 30, 1979]

§ 1.1234–2 Special rule for grantors of straddles applicable to certain options granted on or before September 1, 1976.

(a) *In general.* Section 1234(c)(1) provides a special rule applicable in the case of gain on the lapse of an option granted by the taxpayer as part of a straddle. In such a case, the gain shall be deemed to be gain from the sale or exchange of a capital asset held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) on the day that the option expired. Thus, such gain shall be treated as a short-term capital gain, as defined in section 1222(1). Section 1234(c)(1) does not apply to any person who holds securities (including options to acquire or sell securities) for sale to customers in the ordinary course of his trade or business.

(b) *Definitions.* The following definitions apply for purposes of section 1234(c) and this section.

(1) *Straddle.* The term *straddle* means a simultaneously granted combination of an option to buy (i.e., a *call*) and an option to sell (i.e., a *put*) the same quantity of a security at the same price during the same period of time.

(2) *Security.* The term *security* has the meaning assigned to such term by section 1236(c) and the regulations thereunder. Thus, for example, the term *security* does not include commodity futures.

(3) *Grantor.* The term *grantor* means the writer or issuer of the option contracts making up the straddle.

(4) *Multiple option.* The term *multiple option* means a simultaneously granted combination of an option to buy plus an option to sell plus one or more additional options to buy or sell a security.

(c) *Special rules in the case of a multiple option.* (1) If, in the case of a multiple option, the number of the options to sell and the number of the options to buy are the same and if the terms of all of the options are identical (as to the quantity of the security, price, and period of time), then each of the options contained in the multiple option shall be deemed to be a component of a straddle for purposes of section 1234(c)(1) and paragraph (a) of this section.

(2) If, in the case of a multiple option, the number of the options to sell and the number of the options to buy are not the same or if the terms of all of the options are not identical (as to the quantity of the security, price, and period of time), then section 1234(c)(1) applies to gain on the lapse of an option granted as part of the multiple option only if:

(i) The grantor of the multiple option identifies the two options which comprise each straddle contained in the multiple option in the manner prescribed in subparagraph (3) of this paragraph; or

(ii) It is clear from the facts and circumstances that the lapsed option was part of a straddle. See example (6) of paragraph (f) of this section. A multiple option to which this subdivision applies may not be regarded as consisting of a number of straddles which exceeds the lesser of the options to sell or the options to buy as the case may be. For example, if a multiple option of five puts and four calls is granted it may not be regarded as consisting of more than four straddles, although the particular facts and circumstances could dictate that the option consists of less than four straddles.

(3) The identification required under subparagraph (2)(i) of this paragraph shall be made by the grantor indicating in his records, to the extent feasible, the individual serial number of, or other characteristic symbol imprinted

upon, each of the two individual options which comprise the straddle, or by adopting any other method of identification satisfactory to the Commissioner. Such identification must be made before the expiration of the 15th day after the day on which the multiple option is granted. The preceding sentence shall apply only with respect to multiple options granted after January 24, 1972. In computing the 15-day period prescribed by this paragraph, the first day of such period is the day following the day on which the multiple option is granted.

(d) *Allocation of premium*. The allocation of a premium received for a straddle or a multiple option between or among the component options thereof shall be made on the basis of the relative market value of such component options at the time of their issuance or on any other reasonable and consistently applied basis which is acceptable to the Commissioner.

(e) *Effective date*—(1) *In general*. This section, relating to special rules for grantors of straddles, shall apply only with respect to straddle transactions entered into after January 25, 1965, and before September 2, 1976.

(2) *Special rule*. For a special rule with respect to the identification of a straddle granted as part of a multiple option, see paragraph (c).

(f) *Illustrations*. The application of section 1234(c) and this section may be illustrated by the following examples:

Example 1. On February 1, 1971, taxpayer A, who files his income tax returns on a calendar year basis, issues a straddle for 100 shares of X Corporation stock and receives a premium of $1,000. The options comprising the straddle were to expire on August 10, 1971. A has allocated $450 (45 percent of $1,000) of the premium to the put and $550 (55 percent of $1,000) to the call. On March 1, 1971, B, the holder of the put, exercises his option. C, the holder of the call, fails to exercise his option prior to its expiration. As a result of C's failure to exercise his option, A realizes a short-term capital gain of $550 (that part of the premium allocated to the call) on August 10, 1971.

Example 2. Assume the same facts as in example (1), except that C exercises his call on March 1, 1971, and B fails to exercise his put prior to its expiration. As a result of B's failure to exercise his option, A realizes a short-term capital gain of $450 (that part of the premium allocated to the put) on August 10, 1971.

Example 3. Assume the same facts as in example (1), except that both B and C fail to exercise their respective options. As a result of the failure of B and C to exercise their options, A realizes short-term capital gains of $1,000 (the premium for granting the straddle) on August 10, 1971.

Example 4. On March 1, 1971, taxpayer D issues a multiple option containing five puts and five calls. Each put and each call is for the same number of shares of Y Corporation stock, at the same price, and for the same period of time. Thus, each of the puts and calls is deemed to be a component part of a straddle. The puts and calls comprising the multiple option were to expire on September 10, 1971. All of the puts are exercised, and all of the calls lapse. As a result of the lapse of the calls, D realizes a short-term capital gain on September 10, 1971, in the amount of that part of the premium for the multiple option which is allocable to all of the calls.

Example 5. Assume the same facts as in example (4) except that one of the puts and two of the calls lapse and the remaining puts and calls are exercised. As a result, on September 10, 1971, D realizes a short-term capital gain in the amount of that part of the premium for the multiple option which is allocable to both of the lapsed calls and the lapsed put.

Example 6. On March 1, 1971, taxpayer E issues a multiple option containing five puts and four calls. Each put and call is for the same number of shares of Y Corporation stock at the same price and for the same period of time, E does not identify the puts and calls as parts of straddles in the manner prescribed in paragraph (c)(3) of this section. However, because the terms of all of the puts and all of the calls are identical four of the puts and four of the calls are deemed to be a component part of a straddle. The puts and calls comprising the multiple option were to expire on September 10, 1971. Four of the puts are exercised and the four calls and one of the puts lapse. As a result, on September 10, 1971, E realizes short-term capital gain in the amount of that part of the premium for the multiple option which is allocable to the four lapsed calls and realizes ordinary income in the amount of that part of such premium which is allocable to the lapsed put. If E had identified four of the puts and four of the calls as constituting parts of straddles in the manner prescribed in paragraph (c)(3) of this section and the put that lapsed constituted part of a straddle, then the gain on the lapse of the put would also be short-term capital gain.

Example 7. Assume the same facts as in example (6) except that two of the puts are for Y Corporation stock at a price which is greater than that of the other puts and the other calls and that two of the calls expire on October 10, 1971. Additionally, assume

that the put which lapses is at the lower price. The two puts offering the Y Corporation stock at the greater price and the two calls with the later expiration date cannot be deemed to be component parts of a straddle. Thus, only two of the puts and two of the calls are deemed to be a component part of a straddle. As a result, E realizes income as follows:

(i) On September 10, 1971, short-term capital gain in the amount of that part of the premium for the multiple option which is allocable to the two lapsed calls with the expiration date of September 10, 1971, and ordinary income in the amount of that part of such premium which is allocable to the lapsed put. If E had identified two of the puts at the lower price and the two calls with the expiration date of September 10, 1971, as constituting parts of straddles in the manner prescribed in paragraph (c)(3) of this section and if the put that lapsed was one of those identified as constituting a part of a straddle, then the gain on the lapse of that put would also be short-term capital gain.

(ii) On October 10, 1971, ordinary income in the amount of that part of the premium for the multiple option which is allocable to the lapsed calls with an expiration date of October 10, 1971.

[T.D. 7152, 36 FR 24801, Dec. 23, 1971, as amended by T.D. 7210, 37 FR 20688, Oct. 3, 1972; T.D. 7652, 44 FR 62282, Oct. 30, 1979; 44 FR 67657, Nov. 27, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1234–3 Special rules for the treatment of grantors of certain options granted after September 1, 1976.

(a) *In general.* In the case of the grantor of an option (including an option granted as part of a straddle or multiple option), gain of loss from any closing transaction with respect to, and gain on the lapse of, an option in property shall be treated as a gain or loss from the sale or exchange of a capital asset held not more than 1 year. (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(b) *Definitions.* The following definitions apply for purposes of this section.

(1) The term *closing transaction* means any termination of a grantor's obligation under an option to buy property (a *call*) or an option to sell property (a *put*) other than through the exercise or lapse of the option. For example, the grantor of a call may effectively terminate his obligation under the option by either:

(i) Repurchasing the option from the holder or

(ii) Purchasing from an options exchange a call with terms identical to the original option granted and designating the purchase as a closing transaction.

A put or call purchased to make a closing transaction is identical as to striking price and expiration date. Such put or call need not match the granted option in time of creation, date of acquisition, cost of the entire option or units therein, or number of units subject to the option. If such put or call terminates only part of a grantor's obligation under the granted option, a closing transaction is made as to that part.

(2) The term *property* means stocks and securities (including stocks and securities dealt with on a *when issued* basis), commodities, and commodity futures.

(3) The term *grantor* means the writer or issuer of an option.

(4) The term *straddle* means a simultaneously granted combination of an option to buy and an option to sell the same quantity of property at the same price during the same period of time.

(5) The term *multiple option* means a simultaneously granted combination of an option to buy plus an option to sell plus one or more additional options to buy or sell property.

(c) *Nonapplicability to broker-dealers.* The provisions of this section do not apply to any option granted in the ordinary course of the taxpayer's trade or business of granting options. However, the provisions of this section do apply to:

(1) Gain from any closing transaction with respect to an option and gain on lapse of an option if gain on the sale or exchange of the option would be considered capital gain by a dealer in securities under section 1236(a) and the regulations thereunder, and

(2) Loss from any closing transaction with respect to an option if loss on the sale or exchange of the option would not be considered ordinary loss by a dealer in securities under section 1236(b) and the regulations thereunder.

The preceding sentence shall be applied with respect to dealers in *property* (as

defined in paragraph (b)(2) of this section) and without regard to the limitation of the applicability of section 1236 to dealers in securities.

(d) *Nonapplicability to compensatory options.* Section 1234 does not apply to options to purchase stock or other property which are issued as compensation for services, as described in sections 61, 83, and 421 and the regulations thereunder.

(e) *Premium allocation for simultaneously granted options.* The allocation of a premium received for a straddle or multiple option between or among the component options thereof shall be made on the basis of the relative market value of the component options at the time of their issuance or on any other reasonable and consistently applied basis which is acceptable to the Commissioner.

(f) *Effective date.* This section, relating to special rules for the treatment of grantors of certain options, shall apply to options granted after September 1, 1976.

[T.D. 7652, 44 FR 62282, Oct. 30, 1979; 44 FR 67657, Nov. 27, 1979]

§ 1.1234–4 Hedging transactions.

The character of gain or loss on an acquired or a written option that is (or is identified as being) part of a hedging transaction is determined under the rules of § 1.1221–2.

[T.D. 8555, 59 FR 36367, July 18, 1994]

§ 1.1235–1 Sale or exchange of patents.

(a) *General rule.* Section 1235 provides that a transfer (other than by gift, inheritance, or devise) of all substantial rights to a patent, or of an undivided interest in all such rights to a patent, by a holder to a person other than a related person constitutes the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), whether or not payments therefor are:

(1) Payable periodically over a period generally coterminous with the transferee's use of the patent, or

(2) Contingent on the productivity, use, or disposition of the property transferred.

(b) *Scope of section 1235.* If a transfer is not one described in paragraph (a) of this section, section 1235 shall be disregarded in determining whether or not such transfer is the sale or exchange of a capital asset. For example, a transfer by a person other than a holder or a transfer by a holder to a related person is not governed by section 1235. The tax consequences of such transfers shall be determined under other provisions of the internal revenue laws.

(c) *Special rules*—(1) *Payments for infringement.* If section 1235 applies to the transfer of all substantial rights to a patent (or an undivided interest therein), amounts received in settlement of, or as the award of damages in, a suit for compensatory damages for infringement of the patent shall be considered payments attributable to a transfer to which section 1235 applies to the extent that such amounts relate to the interest transferred. For taxable years beginning before January 1, 1964, see section 1304, as in effect before such date, and § 1.1304A–1 for treatment of compensatory damages for patent infringement.

(2) *Payments to an employee.* Payments received by an employee as compensation for services rendered as an employee under an employment contract requiring the employee to transfer to the employer the rights to any invention by such employee are not attributable to a transfer to which section 1235 applies. However, whether payments received by an employee from his employer (under an employment contract or otherwise) are attributable to the transfer by the employee of all substantial rights to a patent (or an undivided interest therein) or are compensation for services rendered the employer by the employee is a question of fact. In determining which is the case, consideration shall be given not only to all the facts and circumstances of the employment relationship but also to whether the amount of such payments depends upon the production, sale, or use by, or the value to, the employer of the patent rights transferred by the employee. If it is determined that payments are attributable to the transfer of patent rights, and all other requirements under section 1235 are met, such payments shall be treated as

proceeds derived from the sale of a patent.

(3) *Successive transfers.* The applicability of section 1235 to transfers of undivided interest in patents, or to successive transfers of such rights, shall be determined separately with respect to each transfer. For example, X, who is a holder, and Y, who is not a holder, transfer their respective two-thirds and one-third undivided interests in a patent to Z. Assume the transfer by X qualifies under section 1235 and that X in a later transfer acquires all the rights with respect to Y's interest, including the rights to payments from Z. One-third of all the payments thereafter received by X from Z are not attributable to a transfer to which section 1235 applies.

(d) *Payor's treatment of payments in a transfer under section 1235.* Payments made by the transferee of patent rights pursuant to a transfer satisfying the requirements of section 1235 are payments of the purchase price for the patent rights and are not the payment of royalties.

(e) *Effective date.* Amounts received or accrued, and payments made or accrued, during any taxable year beginning after December 31, 1953 and ending after August 16, 1954, pursuant to a transfer satisfying the requirements of section 1235, whether such transfer occurred in a taxable year to which the Internal Revenue Code of 1954 applies, or in a year prior thereto, are subject to the provisions of section 1235.

(f) *Nonresident aliens.* For the special rule relating to nonresident aliens who have gains arising from a transfer to which section 1235 applies, see section 871 and the regulations thereunder. For withholding of tax from income of nonresident aliens, see section 1441 and the regulations thereunder.

[T.D. 6500, 25 FR 12014, Nov. 26, 1960, as amended by T.D. 6885, 31 FR 7803, June 2, 1966; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1235–2 Definition of terms.

For the purposes of section 1235 and § 1.1235–1:

(a) *Patent.* The term *patent* means a patent granted under the provisions of title 35 of the United States Code, or any foreign patent granting rights generally similar to those under a United States patent. It is not necessary that the patent or patent application for the invention be in existence if the requirements of section 1235 are otherwise met.

(b) *All substantial rights to a patent.* (1) The term *all substantial rights to a patent* means all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent (or an undivided interest therein) are transferred. The term *all substantial rights to a patent* does not include a grant of rights to a patent:

(i) Which is limited geographically within the country of issuance;

(ii) Which is limited in duration by the terms of the agreement to a period less than the remaining life of the patent;

(iii) Which grants rights to the grantee, in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant; or

(iv) Which grants to the grantee less than all the claims or inventions covered by the patent which exist and have value at the time of the grant.

The circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer, shall be considered in determining whether or not all substantial rights to a patent are transferred in a transaction.

(2) Rights which are not considered substantial for purposes of section 1235 may be retained by the holder. Examples of such rights are:

(i) The retention by the transferor of legal title for the purpose of securing performance or payment by the transferee in a transaction involving transfer of an exclusive license to manufacture, use, and sell for the life of the patent;

(ii) The retention by the transferor of rights in the property which are not inconsistent with the passage of ownership, such as the retention of a security interest (such as a vendor's lien), or a reservation in the nature of a condition subsequent (such as a provision for forfeiture on account of nonperformance).

(3) Examples of rights which may or may not be substantial, depending

upon the circumstances of the whole transaction in which rights to a patent are transferred, are:

(i) The retention by the transferor of an absolute right to prohibit sublicensing or subassignment by the transferee;

(ii) The failure to convey to the transferee the right to use or to sell the patent property.

(4) The retention of a right to terminate the transfer at will is the retention of a substantial right for the purposes of section 1235.

(c) *Undivided interest*. A person owns an *undivided interest* in all substantial rights to a patent when he owns the same fractional share of each and every substantial right to the patent. It does not include, for example, a right to the income from a patent, or a license limited geographically, or a license which covers some, but not all, of the valuable claims or uses covered by the patent. A transfer limited in duration by the terms of the instrument to a period less than the remaining life of the patent is not a transfer of an undivided interest in all substantial rights to a patent.

(d) *Holder*. (1) The term *holder* means any individual:

(i) Whose efforts created the patent property and who would qualify as the *original and first* inventor, or joint inventor, within the meaning of title 35 U.S.C., or

(ii) Who has acquired his interest in the patent property in exchange for a consideration paid to the inventor in money or money's worth prior to the actual reduction of the invention to practice (see paragraph (e) of this section), provided that such individual was neither the employer of the inventor nor related to him (see paragraph (f) of this section). The requirement that such individual is neither the employer of the inventor nor related to him must be satisfied at the time when the substantive rights as to the interest to be acquired are determined, and at the time when the consideration in money or money's worth to be paid is definitely fixed. For example, if prior to the actual reduction to practice of an invention an individual who is neither the employer of the inventor nor related to him agrees to pay the inventor a sum of money definitely fixed as to amount in return for an undivided one-half interest in rights to a patent and at a later date, when such individual has become the employer of the inventor, he pays the definitely fixed sum of money pursuant to the earlier agreement, such individual will not be denied the status of a holder because of such employment relationship.

(2) Although a partnership cannot be a holder, each member of a partnership who is an individual may qualify as a holder as to his share of a patent owned by the partnership. For example, if an inventor who is a member of a partnership composed solely of individuals uses partnership property in the development of his invention with the understanding that the patent when issued will become partnership property, each of the inventor's partners during this period would qualify as a holder. If, in this example, the partnership were not composed solely of individuals, nevertheless, each of the individual partners' distributive shares of income attributable to the transfer of all substantial rights to the patent or an undivided interest therein, would be considered proceeds from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(3) An individual may qualify as a holder whether or not he is in the business of making inventions or in the business of buying and selling patents.

(e) *Actual reduction to practice*. For the purposes of determining whether an individual is a holder under paragraph (d) of this section, the term *actual reduction to practice* has the same meaning as it does under section 102(g) of title 35 of the United States Code. Generally, an invention is reduced to actual practice when it has been tested and operated successfully under operating conditions. This may occur either before or after application for a patent but cannot occur later than the earliest time that commercial exploitation of the invention occurs.

(f) *Related person*. (1) The term *related person* means one whose relationship to another person at the time of the transfer is described in section 267(b), except that the term does not include a

brother or sister, whether of the whole or the half blood. Thus, if a holder transfers all his substantial rights to a patent to his brother or sister, or both, such transfer is not to a related person.

(2) If, prior to September 3, 1958, a holder transferred all his substantial rights to a patent to a corporation in which he owned more than 50 percent in value of the outstanding stock, he is considered as having transferred such rights to a related person for the purpose of section 1235. On the other hand, if a holder, prior to September 3, 1958, transferred all his substantial rights to a patent to a corporation in which he owned 50 percent or less in value of the outstanding stock and his brother owned the remaining stock, he is not considered as having transferred such rights to a related person since the brother relationship is to be disregarded for purposes of section 1235.

(3) If, subsequent to September 2, 1958, a holder transfers all his substantial rights to a patent to a corporation in which he owns 25 percent or more in value of the outstanding stock, he is considered as transferring such rights to a related person for the purpose of section 1235. On the other hand if a holder, subsequent to September 2, 1958, transfers all his substantial rights to a patent to a corporation in which he owns less than 25 percent in value of the outstanding stock and his brother owns the remaining stock, he is not considered as transferring such rights to a related person since the brother relationship is to be disregarded for purposes of section 1235.

(4) If a relationship described in section 267(b) exists independently of family status, the brother-sister exception, described in subparagraphs (1), (2), and (3) of this paragraph, does not apply. Thus, if a holder transfers all his substantial rights to a patent to the fiduciary of a trust of which the holder is the grantor, the holder and the fiduciary are related persons for purposes of section 1235(d). (See section 267(b)(4).) The transfer, therefore, would not qualify under section 1235(a). This result obtains whether or not the fiduciary is the brother or sister of the holder since the disqualifying relationship exists because of the grantor-fiduciary status and not because of family status.

[T.D. 6500, 25 FR 12014, Nov. 26, 1960, as amended by T.D. 6852, 30 FR 12730, Oct. 6, 1965; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1236–1 Dealers in securities.

(a) *Capital gains*. Section 1236(a) provides that gain realized by a dealer in securities from the sale or exchange of a security (as defined in paragraph (c) of this section) shall not be considered as gain from the sale or exchange of a capital asset unless:

(1) The security is, before the expiration of the thirtieth day after the date of its acquisition, clearly identified in the dealer's records as a security held for investment or, if acquired before October 20, 1951, was so identified before November 20, 1951; and

(2) The security is not held by the dealer primarily for sale to customers in the ordinary course of his trade or business at any time after the identification referred to in subparagraph (1) of this paragraph has been made.

Unless both of these requirements are met, the gain is considered as gain from the sale of assets held by the dealer primarily for sale to customers in the course of his business.

(b) *Ordinary losses*. Section 1236(b) provides that a loss sustained by a dealer in securities from the sale or exchange of a security shall not be considered a loss from the sale or exchange of property which is not a capital asset if at any time after November 19, 1951, the security has been clearly identified in the dealer's records as a security held for investment. Once a security has been identified after November 19, 1951, as being held by the dealer for investment, it shall retain that character for purposes of determining loss on its ultimate disposition, even though at the time of its disposition the dealer holds it primarily for sale to his customers in the ordinary course of his business. However, section 1236 has no application to the extent that section 582(c) applies to losses of banks.

(c) *Definitions*—(1) *Security*. For the purposes of this section, the term *security* means any share of stock in any corporation, any certificate of stock or interest in any corporation, any note, bond, debenture, or other evidence of

indebtedness, or any evidence of any interest in, or right to subscribe to or purchase, any of the foregoing.

(2) *Dealer in securities.* For definition of a *dealer in securities,* see the regulations under section 471.

(d) *Identification of security in dealer's records.* (1) A security is clearly identified in the dealer's records as a security held for investment when there is an accounting separation of the security from other securities, as by making appropriate entries in the dealer's books of account to distinguish the security from inventories and to designate it as an investment and by (i) indicating with such entries, to the extent feasible, the individual serial number of, or other characteristic symbol imprinted upon, the individual security, or (ii) adopting any other method of identification satisfactory to the Commissioner.

(2) In computing the 30-day period prescribed by section 1236(a), the first day of the period is the day following the date of acquisition. Thus, in the case of a security acquired on March 18, 1957, the 30-day period expires at midnight on April 17, 1957.

[T.D. 6500, 25 FR 12015, Nov. 26, 1960, as amended by T.D. 6726, 29 FR 5667, Apr. 29, 1964]

§ 1.1237–1 Real property subdivided for sale.

(a) *General rule*—(1) *Introductory.* This section provides a special rule for determining whether the taxpayer holds real property primarily for sale to customers in the ordinary course of his business under section 1221(1). This rule is to permit taxpayers qualifying under it to sell real estate from a single tract held for investment without the income being treated as ordinary income merely because of subdividing the tract or of active efforts to sell it. The rule is not applicable to dealers in real estate or to corporations, except a corporation making such sales in a taxable year beginning after December 31, 1954, if such corporation qualifies under the provisions of paragraph (c)(5)(iv) of this section.

(2) *When subdividing and selling activities are to be disregarded.* When its conditions are met, section 1237 provides that if there is no other substantial evidence that a taxpayer holds real estate primarily for sale to customers in the ordinary course of his business, he shall not be considered a real estate dealer holding it primarily for sale merely because he has (i) subdivided the tract into lots (or parcels) and (ii) engaged in advertising, promotion, selling activities or the use of sales agents in connection with the sale of lots in such subdivision. Such subdividing and selling activities shall be disregarded in determining the purpose for which the taxpayer held real property sold from a subdivision whenever it is the only substantial evidence indicating that the taxpayer has ever held the real property sold primarily for sale to customers in the ordinary course of his business.

(3) *When subdividing and selling activities are to be taken into account.* When other substantial evidence tends to show that the taxpayer held real property for sale to customers in the ordinary course of his business, his activities in connection with the subdivision and sale of the property sold shall be taken into account in determining the purpose for which the taxpayer held both the subdivided property and any other real property. For example, such other evidence may consist of the taxpayer's selling activities in connection with other property in prior years during which he was engaged in subdividing or selling activities with respect to the subdivided tract, his intention in prior years (or at the time of acquiring the property subdivided) to hold the tract primarily for sale in his business, his subdivision of other tracts in the same year, his holding other real property for sale to customers in the same year, or his construction of a permanent real estate office which he could use in selling other real property. On the other hand, if the only evidence of the taxpayer's purpose in holding real property consisted of not more than one of the following, in the year in question, such fact would not be considered substantial other evidence:

(i) Holding a real estate dealer's license;

(ii) Selling other real property which was clearly investment property;

(iii) Acting as a salesman for a real estate dealer, but without any financial interest in the business; or

(iv) Mere ownership of other vacant real property without engaging in any selling activity whatsoever with respect to it.

If more than one of the above exists, the circumstances may or may not constitute substantial evidence that the taxpayer held real property for sale in his business, depending upon the particular facts in each case.

(4) *Section 1237 not exclusive.* (i) The rule in section 1237 is not exclusive in its application. Section 1237 has no application in determining whether or not real property is held by a taxpayer primarily for sale in his business if any requirement under the section is not met. Also, even though the conditions of section 1237 are met, the rules of section 1237 are not applicable if without regard to section 1237 the real property sold would not have been considered real property held primarily for sale to customers in the ordinary course of his business. Thus, the district director may at all times conclude from convincing evidence that the taxpayer held the real property solely as an investment. Furthermore, whether or not the conditions of section 1237 are met, the section has no application to losses realized upon the sale of realty from subdivided property.

(ii) If, owing solely to the application of section 1237, the real property sold is deemed not to have been held primarily for sale in the ordinary course of business, any gain realized upon such sale shall be treated as ordinary income to the extent provided in section 1237(b) (1) and (2) and paragraph (e) of this section. Any additional gain realized upon the sale shall be treated as gain arising from the sale of a capital asset or, if the circumstances so indicate, as gain arising from the sale of real property used in the trade or business as defined in section 1231 (b)(1). For the relationship between sections 1237 and 1231, see paragraph (f) of this section.

(5) *Principal conditions of qualification.* Before section 1237 applies, the taxpayer must meet three basic conditions, more fully explained later: He cannot have held any part of the tract at any time previously for sale in the ordinary course of his business, nor in the year of sale held any other real estate for sale to customers; he cannot make substantial improvements on the tract which increase the value of the lot sold substantially; and he must have owned the property 5 years, unless he inherited it. However, the taxpayer may make certain improvements if they are necessary to make the property marketable if he elects neither to add their cost to the basis of the property, or of any other property, nor to deduct the cost as an expense, and he has held the property at least 10 years. If the requirements of section 1237 are met, gain (but not more than 5 percent of the selling price of each lot) shall be treated as ordinary income in and after the year in which the sixth lot or parcel is sold.

(b) *Disqualification arising from holding real property primarily for sale*—(1) *General rule.* Section 1237 does not apply to any transaction if the taxpayer either:

(i) Held the lot sold (or the tract of which it was a part) primarily for sale in the ordinary course of his business in a prior year, or

(ii) Holds other real property primarily for sale in the ordinary course of his business in the same year in which such lot is sold.

Where either of these elements is present, section 1237 shall be disregarded in determining the proper treatment of any gain arising from such sale.

(2) *Method of applying general rule.* For purposes of this paragraph, in determining whether the lot sold was held primarily for sale in the ordinary course of business in a prior year, the principles of section 1237 shall be applied, whether or not section 1237 was effective for such prior year, if the sale of the lot occurs after December 31, 1953, or, in the case of a corporation meeting the requirements of paragraph (c)(5)(iv) of this section, if the sale of the lot occurs in a taxable year beginning after December 31, 1954. Whether, on the other hand, the taxpayer holds other real property for sale in the ordinary course of his business in the same

year such lot was sold shall be determined without regard to the application of section 1237 to such other real property.

(3) *Attribution rules with respect to the holding of property*. The taxpayer is considered as holding property which he owns individually, jointly, or as a member of a partnership. He is not generally considered as holding property owned by members of his family, an estate or trust, or a corporation. See, however, paragraph (c)(5) (iv)(c) of this section for an exception to this rule. The purpose for which a prior owner held the lot or tract, or his activities, are immaterial except to the extent they indicate the purpose for which the taxpayer has held the lot or tract. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held. The principles of this subparagraph may be illustrated by the following example:

Example: A dealer in real property held a tract of land for sale to customers in the ordinary course of his business for 5 years. He then made a gift of it to his son. As a result of the operation of section 1223(2) the son will have held the property for the period of time required by section 1237. However, he will not qualify for the benefits of section 1237 because, there being no evidence to the contrary, the circumstances involved establish that the son holds the property for sale to customers, as did his father.

(c) *Disqualification arising from substantial improvements*—(1) *General rule*. Section 1237 will not apply if the taxpayer or certain others make improvements on the tract which are substantial and which substantially increase the value of the lot sold. Certain improvements are not substantial within the meaning of section 1237(a)(2) if they are necessary to make the lot marketable at the prevailing local price and meet the other conditions of section 1237(b)(3). See subparagraph (5) of this paragraph.

(2) *Improvements made or deemed to be made by the taxpayer*. Certain improvements made by the taxpayer or made under a contract of sale between the taxpayer and the buyer make section 1237 inapplicable.

(i) For the purposes of section 1237 (a)(2) the taxpayer is deemed to have made any improvements on the tract while he held it which are made by:

(*a*) The taxpayer's whole or half brothers and sisters, spouse, ancestors and lineal descendants.

(*b*) A corporation controlled by the taxpayer. A corporation is controlled by the taxpayer if he controls, as the result of direct ownership, constructive ownership, or otherwise, more than 50 percent of the corporation's voting stock.

(*c*) A partnership of which the taxpayer was a member at the time the improvements were made.

(*d*) A lessee if the improvement takes the place of a payment of rental income. See section 109 and the regulations thereunder.

(*e*) A Federal, State, or local government, or political subdivision thereof, if the improvement results in an increase in the taxpayer's basis for the property, as it would, for example, from a special tax assessment for paving streets.

(ii) The principles of subdivision (i) of this subparagraph may be illustrated by the following example:

Example: A held a tract of land for 3 years during which he made substantial improvements thereon which substantially enhanced the value of every lot on the tract. A then made a gift of the tract to his son. The son made no further improvements on the tract but held it for 3 years and then sold several lots therefrom. The son is not entitled to the benefits of section 1237 since under section 1237(a)(2) he is deemed to have made the substantial improvements made by his father, and under section 1223(2) he is treated as having held the property for the period during which his father held it. Thus, the disqualifying improvements are deemed to have been made by the son while the tract was held by him. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held.

(iii) The taxpayer is also charged with making any improvements made pursuant to a contract of sale entered into between the taxpayer and the buyer. Therefore, the buyer, as well as the taxpayer, may make improvements which prevent the application of section 1237.

(*a*) If a contract of sale obligates either the taxpayer or the buyer to make a substantial improvement which would substantially increase the value of the lot, the taxpayer may not claim the application of section 1237 unless

the obligation to improve the lot ceases (for any reason other than that the improvement has been made) before or within the period, prescribed by section 6511, within which the taxpayer may file a claim for credit or refund of an overpayment of his tax on the gain from the sale of the lot. The following example illustrates this rule:

Example: In 1956, A sells several lots from a tract he has subdivided for sale. Section 1237 would apply to the sales of these lots except that in the contract of sale, A agreed to install sewers, hard surface roads, and other utilities which would increase the value of the lots substantially. If in 1957, instead of requiring the improvements, the buyer releases A from this obligation, A may then claim the application of section 1237 to the sale of lots in 1956 in computing his income tax for 1956, since the period of limitations in which A may file a claim for credit or refund of an overpayment of his 1956 income tax has not expired.

(*b*) An improvement is made pursuant to a contract if the contract imposes an obligation on either party to make the improvement, but not if the contract merely places restrictions on the improvements, if any, either party may make. The following example illustrates this rule:

Example: B sells several lots from a tract which he has subdivided. Each contract of sale prohibits the purchaser from building any structure on his lot except a personal residence costing $15,000 or more. Even if the purchasers build such residences, that does not preclude B from applying section 1237 to the sales of such lots, since the contracts did not obligate the purchasers to make any improvements.

(iv) Improvements made by a bona fide lessee (other than as rent) or by others not described in section 1237(a)(2) do not preclude the use of section 1237.

(3) *When improvements substantially enhance the value of the lot sold.* Before a substantial improvement will preclude the use of section 1237, it must substantially enhance the value of the lot sold.

(i) The increase in value to be considered is only the increase attributable to the improvement or improvements. Other changes in the market price of the lot, not arising from improvements made by the taxpayer, shall be disregarded. The difference between the value of the lot, including improvements, when the improvement has been completed and an appraisal of its value if unimproved at that time, will disclose the value added by the improvements.

(ii) Whether improvements have substantially increased the value of a lot depends upon the circumstances in each case. If improvements increase the value of a lot by 10 percent or less, such increase will not be considered as substantial, but if the value of the lot is increased by more than 10 percent, then all relevant factors must be considered to determine whether, under such circumstances, the increase is substantial.

(iii) Improvement may increase the value of some lots in a tract without equally affecting other lots in the same tract. Only the lots whose value was substantially increased are ineligible for application of the rule established by section 1237.

(4) *When an improvement is substantial.* To prevent the application of section 1237, the improvement itself must be substantial in character. Among the improvements considered substantial are shopping centers, other commercial or residential buildings, and the installation of hard surface roads or utilities such as sewers, water, gas, or electric lines. On the other hand a temporary structure used as a field office, surveying, filling, draining, leveling and clearing operations, and the construction of minimum all-weather access roads, including gravel roads where required by the climate, are not substantial improvements.

(5) *Special rules relating to substantial improvements.* Under certain conditions a taxpayer, including a corporation to which subdivision (iv) of this subparagraph applies, may obtain the benefits of section 1237 whether or not substantial improvements have been made. In addition, an individual taxpayer may, under certain circumstances elect to have substantial improvements treated as necessary and not substantial.

(i) *When an improvement is not considered substantial.* An improvement will not be considered substantial if all of the following conditions are met:

(*a*) The taxpayer has held the property for 10 years. The full 10-year period must elapse, whether or not the taxpayer inherited the property. Although the taxpayer must hold the property 10 years, he need not hold it for 10 years after subdividing it. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held.

(*b*) The improvement consists of the building or installation of water, sewer, or drainage facilities (either surface, sub-surface, or both) or roads, including hard surface roads, curbs, and gutters.

(*c*) The district director with whom the taxpayer must file his return is satisfied that, without such improvement, the lot sold would not have brought the prevailing local price for similar building sites.

(*d*) The taxpayer elects, as provided in subdivision (iii) of this subparagraph, not to adjust the basis of the lot sold or any other property held by him for any part of the cost of such improvement attributable to such lot and not to deduct any part of such cost as an expense.

(ii) *Meaning of similar building site.* A *similar building site* is any real property in the immediate vicinity whose size, terrain, and other characteristics are comparable to the taxpayer's property. For the purpose of determining whether a tract is marketable at the prevailing local price for similar building sites, the taxpayer shall furnish the district director with sufficient evidence to enable him to compare (*a*) the value of the taxpayer's property in an unimproved state with (*b*) the amount for which similar building sites, improved by the installation of water, sewer, or drainage facilities or roads, have recently been sold, reduced by the present cost of such improvements. Such comparison may be made and expressed in terms of dollars per square foot, dollars per acre, or dollars per front foot, or in any other suitable terms depending upon the practice generally followed by real estate dealers in the taxpayer's locality. The taxpayer shall also furnish evidence, where possible, of the best bona fide offer received for the tract or a lot thereof just before making the improvement, to assist the district director in determining the value of the tract or lot if it had been sold in its unimproved state. The operation of this subdivision and subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. A has been offered $500 per acre for a tract without roads, water, or sewer facilities which he has owned for 15 years. The adjacent tract has been subdivided and improved with water facilities and hard surface roads, and has sold for $4,000 per acre. The estimated cost of roads and water facilities on the adjacent tract is $2,500 per acre. The prevailing local price for similar building sites in the vicinity would be $1,500 per acre (i.e., $4,000 less $2,500). If A installed roads and water facilities at a cost of $2,500 per acre, his tract would sell for approximately $4,000 per acre. Under section 1237(b)(3) the installation of roads and water facilities does not constitute a substantial improvement if A elects to disregard the cost of such improvements ($2,500 per acre) in computing his cost or other basis for the lots sold from the tract, and in computing his basis for any other property owned by him.

Example 2. Assume the same facts as in example (1) of this subdivision, except that A can obtain $1,600 per acre for his property without improvements. The installation of any substantial improvements would not constitute a necessary improvement under section 1237(b)(3), since the prevailing local price could have been obtained without any improvement.

Example 3. Assume the same facts as in example (1) of this subdivision, except that the adjacent tract has also been improved with sewer facilities, the present cost of which is $1,200 per acre. The installation of the substantial improvements would not constitute a necessary improvement under section 1237(b)(3) on A's part, since the prevailing local price ($4,000 less the sum of $1,200 plus $2,500, or $300) could have been obtained by A without any improvement.

(iii) *Manner of making election.* The election required by section 1237(b)(3)(C) shall be made as follows:

(*a*) The taxpayer shall submit:

(*1*) A plat showing the subdivision and all improvements attributable to him.

(*2*) A list of all improvements to the tract, showing:

(*i*) The cost of such improvements.

(*ii*) Which of the improvements, without regard to the election, he considers *substantial* and which he considers not *substantial*.

(*iii*) Those improvements which are substantial to which the election is to apply, with a fair allocation of their cost to each lot they affect, and the amount by which they have increased the values of such lots.

(*iv*) The date on which each lot was acquired and its basis for determining gain or loss, exclusive of the cost of any improvements listed in subdivision (iii) of this subdivision.

(*3*) A statement that he will neither deduct as an expense nor add to the basis of any lot sold, or of any other property, any portion of the cost of any substantial improvement which substantially increased the value of any lot in the tract and which either he listed pursuant to (*a*)(*2*)(iii) of this subdivision or which the district director deems substantial.

(*b*) The election and the information required under (*a*) of this subdivision shall be submitted to the district director:

(*1*) With the taxpayer's income tax return for the taxable year in which the lots subject to the election were sold, or

(*2*) In the case of a return filed prior to August 14, 1957, either with a timely claim for refund, where the benefits of section 1237 have not been claimed on such return, or, independently, before November 13, 1957, where such benefits have been claimed, or

(*3*) If there is an obligation to make disqualifying improvements outstanding when the taxpayer files his return, with a formal claim for refund at the time of the release of the obligation, if it is then still possible to file a timely claim.

(*c*) Once made, the election as to the necessary improvement costs attributable to any lot sold shall be irrevocable and binding on the taxpayer unless the district director assesses an income tax as to such lot as if it were held for sale in the ordinary course of taxpayer's business. Under such circumstances, in computing gain, the cost or other basis shall be computed without regard to section 1237.

(iv) *Exceptions with respect to necessary* improvements and certain corporations. For taxable years beginning after December 31, 1954, individual taxpayers and certain corporations may obtain the benefits of section 1237 without complying with the provisions of subdivisions (i) (*c*) and (*d*), (ii), and (iii) of this subparagraph if the requirements of section 1237 are otherwise met and if:

(*a*) The property in question was acquired by the taxpayer through the foreclosure of a lien thereon,

(*b*) The lien foreclosed secured the payment of an indebtedness to the taxpayer or (in the case of a corporation) secured the payment of an indebtedness to a creditor who has transferred the foreclosure bid to the taxpayer in exchange for all of the stock of the corporation and other consideration, and

(*c*) In the case of a corporate taxpayer, no shareholder of the corporation holds real property for sale to customers in the ordinary course of his trade or business or holds a controlling interest in another corporation which actually so holds real property, or which, but for the application of this subdivision, would be considered to so hold real property.

Thus, in the case of such property, it is not necessary for the taxpayer to satisfy the district director that the property would not have brought the prevailing local price without improvements or to elect not to add the cost of the improvements to his basis. In addition, if 80 percent or more of the real property owned by a taxpayer is property to which this subdivision applies, the requirements of (*a*) and (*b*) of this subdivision need not be met with respect to property adjacent to such property which is also owned by the taxpayer.

(d) *Holding period required*—(1) *General rules*. To apply section 1237, the taxpayer must either have inherited the lot sold or have held it for 5 years. Generally, the provisions of section 1223 are applicable in determining the period for which the taxpayer has held the property. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. A held a tract of land for 3 years under circumstances otherwise qualifying for section 1237 treatment. He made a gift of the tract to B at a time when the fair market value of the tract exceeded A's basis for the tract. B held the tract for 2 more years under similar circumstances. B then sold 4

lots from the tract. B is entitled to the benefits of section 1237 since under section 1223(2) he held the lots for 5 years and all the other requirements of section 1237 are met.

Example 2. C purchased all the stock in a corporation in 1955. The corporation purchased an unimproved tract of land in 1957. In 1961 the corporation was liquidated under section 333 and C acquired the tract of land. For purposes of section 1237, C's holding period commenced on the date the corporation actually acquired the land in 1957 and not on the date C purchased the stock.

(2) *Rules relating to property acquired upon death.* If the taxpayer inherited the property there is no 5-year holding period required under section 1237. However, any holding period required by any other provision of the Code, such as section 1222, is nevertheless applicable. For purposes of section 1237, neither the survivor's one-half of community property, nor property acquired by survivorship in a joint tenancy, is property acquired by devise or inheritance. The holding period for the surviving joint tenant begins on the date the property was originally acquired.

(e) *Tax consequences if section 1237 applies*—(1) *Introductory.* Where there is no substantial evidence other than subdivision and related selling activities that real property is held for sale in the ordinary course of taxpayer's business and section 1237 applies, section 1237(b)(1) provides a special rule for computing taxable gain. For the relationship between sections 1237 and 1231, see paragraph (f) of this section.

(2) *Characterization of gain and its relation to selling expenses.* (i) When the taxpayer has sold less than 6 lots or parcels from the same tract up to the end of his taxable year, the entire gain will be capital gain. (Where the land is used in a trade or business, see paragraph (f) of this section.) In computing the number of lots or parcels sold, two or more contiguous lots sold to a single buyer in a single sale will be counted as only one parcel. The following example illustrates this rule:

Example: A meets all the conditions of section 1237 in subdividing and selling a single tract. In 1956 he sells 4 lots to B, C, D, and E. In the same year F buys 3 adjacent lots. Since A has sold only 5 lots or parcels from the tract, any gain A realizes on the sales will be capital gain.

(ii) If the taxpayer has sold the sixth lot or parcel from the same tract within the taxable year, then the amount, if any, by which 5 percent of the selling price of each lot exceeds the expenses incurred in connection with its sale or exchange, shall, to the extent it represents gain, be ordinary income. Any part of the gain not treated as ordinary income will be treated as capital gain. (Where the land is used in a trade or business, see paragraph (f) of this section.) Five percent of the selling price of each lot sold from the tract in the taxable year the sixth lot is sold and thereafter is, to the extent it represents gain, considered ordinary income. However, all expenses of sale of the lot are to be deducted first from the 5 percent of the gain which would otherwise be considered ordinary income, and any remainder of such expenses shall reduce the gain upon the sale or exchange which would otherwise be considered capital gain. Such expenses cannot be deducted as ordinary business expenses from other income. The 5-percent rule applies to all lots sold from the tract in the year the sixth lot or parcel is sold. Thus, if the taxpayer sells the first 6 lots of a single tract in one year, 5 percent of the selling price of each lot sold shall be treated as ordinary income and reduced by the selling expenses. On the other hand, if the taxpayer sells the first 3 lots of a single tract in 1955, and the next 3 lots in 1956, only the gain realized from the sales made in 1956 shall be so treated. For the effect of a 5-year interval between sales, see paragraph (g)(2) of this section. The operation of this subdivision may be illustrated by the following examples:

Example 1. Assume the selling price of the sixth lot of a tract is $10,000, the basis of the lot in the hands of the taxpayer is $5,000, and the expenses of sale are $750. The amount of gain realized by the taxpayer is $4,250, of which the amount of ordinary income attributable to the sale is zero, computed as follows:

Selling price		$10,000
Basis		5,000
Excess over basis		5,000
5 percent of selling price	500	
Expenses of sale	750	
Amount of gain realized treated as ordinary income		0
Excess over basis		5,000

5 percent of selling price	500	
Excess of expenses over 5 percent of selling price	250	
		750
Amount of gain realized from sale of property not held for sale in ordinary course of business		4,250

Example 2. Assume the same facts as in Example 1, except that the expenses of sale of such sixth lot are $300. The amount of gain realized by the taxpayer is $4,700, of which the amount of ordinary income attributable to the sale is $200, computed as follows:

Selling price		$10,000
Basis		5,000
Excess over basis		5,000
5 percent of selling price	$500	
Expenses of sale	300	
Amount of gain realized treated as ordinary income		200
Excess over basis		5,000
5 percent of selling price	500	
Excess of expenses over 5 percent of selling price	0	
		500
Amount of gain realized from sale of property not held for sale in ordinary course of business		4,500

(iii) In the case of an exchange, the term *selling price* shall mean the fair market value of property received plus any sum of money received in exchange for the lot. See section 1031 for those exchanges in which no gain is recognized. For the purpose of subsections (b) and (c) of section 1237 and paragraphs (e) and (g) of this section, an exchange shall be treated as a sale or exchange whether or not gain or loss is recognized with respect to such exchange.

(f) *Relationship of section 1237 and section 1231.* Application of section 1237 to a sale of real property may, in some cases, result in the property being treated as real property used in the trade or business, as described in section 1231(b)(1). Thus, assuming section 1237 is otherwise applicable, if the lot sold would be considered property described in section 1231(b)(1) except for the fact that the taxpayer subdivided the tract of which it was a part, then evidence of such subdivision and connected sales activities shall be disregarded and the lot sold shall be considered real property used in the trade or business. Under such circumstances, any gain or loss realized from the sale shall be treated as gain or loss arising from the sale of real property used in the trade or business.

(g) *Definition of tract*—(1) *Aggregation of properties.* For the purposes of section 1237, the term *tract* means either (i) a single piece of real property or (ii) two or more pieces of real property if they were contiguous at any time while held by the taxpayer, or would have been contiguous but for the interposition of a road, street, railroad, stream, or similar property. Properties are contiguous if their boundaries meet at one or more points. The single piece of contiguous properties need not have been conveyed by a single deed. The taxpayer may have assembled them over a period of time and may hold them separately, jointly, or as a partner, or in any combination of such forms of ownership.

(2) *When a subdivision will be considered a new tract.* If the taxpayer sells or exchanges no lots from the tract for a period of 5 years after the sale or exchange of at least 1 lot in the tract, then the remainder of the tract shall be deemed a new tract for the purpose of counting the number of lots sold from the same tract under section 1237(b)(1). The pieces in the new tract need not be contiguous. The 5-year period is measured between the dates of the sales or exchanges.

(h) *Effective date.* This section shall apply only to gain realized on sales made after December 31, 1953, or, in the case of a person meeting the requirements of paragraph (c)(5)(iv) of this section, if the sale of the lot occurs in a taxable year beginning after December 31, 1954. Pursuant to section 7851(a)(1)(C), the regulations prescribed in this section (other than subdivision (iv) of paragraph (c)(5)) shall also apply to taxable years beginning before January 1, 1954, and ending after December 31, 1953, and to taxable years beginning after December 31, 1953, and ending before August 17, 1954, although such years are subject to the Internal Revenue Code of 1939. Irrespective of whether the taxable year involved is subject to the Internal Revenue Code of 1939 or the Internal Revenue Code of 1954, sales or exchanges made before January 1, 1954, shall be taken into account to determine whether: (1) No

sales or exchanges have been made for 5 years, under section 1237(c), and (2) more than 5 lots or parcels have been sold or exchanged from the same tract, under section 1237(b)(1). Thus, if the taxpayer sold 5 lots from a single tract in 1950, and another lot is sold in 1954, the lot sold in 1954 constitutes the *sixth lot* sold from the original tract. On the other hand, if the first 5 lots were sold in 1948, the sale made in 1954 shall be deemed to have been made from a new tract.

[T.D. 6500, 25 FR 12016, Nov. 26, 1960]

§ 1.1238–1 Amortization in excess of depreciation.

(a) *In general.* Section 1238 provides that if a taxpayer is entitled to a deduction for amortization of an emergency facility under section 168, and if the facility is later sold or exchanged, any gain realized shall be considered as ordinary income to the extent that the amortization deduction exceeds normal depreciation. Thus, under section 1238 gain from a sale or exchange of property shall be considered as ordinary income to the extent that its adjusted basis is less than its adjusted basis would be if it were determined without regard to section 168. If an entire facility is certified under section 168(e), the taxpayer may use allowances for depreciation based on any rate and method which would have been proper if the basis of the facility were not subject to amortization under section 168, in determining what the adjusted basis of the facility would be if it were determined without regard to section 168. If only a portion of a facility is certified under section 168(e), allowances for depreciation based on the rate and method properly used with respect to the uncertified part of the facility are used in determining what the adjusted basis of the facility would be if it were determined without regard to section 168. The principles of this paragraph may be illustrated by the following examples:

Example 1. On December 31, 1954, a taxpayer making his income tax returns on a calendar year basis acquires at a cost of $20,000 an emergency facility (used in his business) 50 percent of the adjusted basis of which has been certified under section 168(e). The facility would normally have a useful life of 20 years and a salvage value of $2,000 allocable equally between the certified and uncertified portions. Under section 168 the taxpayer elects to begin the 60-month amortization period on January 1, 1955. He takes amortization deductions with respect to the certified portion in the amount of $4,000 for the years 1955 and 1956 (24 months). On December 31, 1956, he sells the facility for a price of $19,000 which is allocable equally between the certified and uncertified portions. The adjusted basis of the certified portion on that date is $6,000 ($10,000 cost, less $4,000 amortization). With respect to the uncertified portion, the straight line method of depreciation is used and a deduction for depreciation in the amount of $450 is claimed and allowed for the year 1955. The adjusted basis of the uncertified portion on January 1, 1956, is $9,550 ($10,000 cost, less $450 depreciation). The depreciation allowance for the uncertified portion for the year 1956 would be limited to $50, the amount by which the adjusted basis of such portion at the beginning of the year exceeded its aliquot portion of the sales price. Thus, on December 31, 1956, the adjusted basis of the uncertified portion would be $9,500. Without regard to section 168, and using the rate and method the taxpayer properly applied to the uncertified portion of the facility, the adjusted basis of the certified portion on December 31, 1956, would be $9,500, computed in the same manner as the adjusted basis of the uncertified portion. The difference between the facility's actual adjusted basis ($15,500) and its adjusted basis determined without regard to section 168 ($19,000), is $3,500. Accordingly, the entire $3,500 gain on the sale of the facility ($19,000 sale price, less $15,500 adjusted basis) is treated as ordinary income.

Example 2. Assume that the entire facility in example (1) had been certified under section 168(e) and that, therefore, the adjusted basis of the facility on December 31, 1956, is $12,000. Assume further that the taxpayer adopts straight line depreciation as a proper method of depreciation for determining the adjusted basis of the facility without regard to section 168. Thus, the adjusted basis, without regard to section 168, would be $19,000. This amount is $7,000 more than the $12,000 adjusted basis under section 168. Hence, the entire $7,000 gain on the sale of the facility ($19,000 sale price less $12,000 adjusted basis) is treated as ordinary income.

(b) *Substituted basis.* If a taxpayer acquires other property in an exchange for an emergency facility with respect to which amortization deductions have been allowed or allowable, and if the basis in his hands of the other property is determined by reference to the basis of the emergency facility, then the

basis of the other property is determined with regard to section 168, and therefore the provisions of section 1238 apply with respect to gain realized on a subsequent sale or exchange of the other property. The provisions of section 1238 also apply to gain realized on the sale or exchange of an emergency facility (or other property acquired, as described in the preceding sentence, in exchange for an emergency facility) by a taxpayer in whose hands the basis of the facility (or other property) is determined by reference to its basis in the hands of another person to whom deductions were allowable or allowed with respect to the facility under section 168.

[T.D. 6500, 25 FR 12020, Nov. 26, 1960, as amended by T.D. 6825, 30 FR 7281, June 2, 1965]

§ 1.1239–1 Gain from sale or exchange of depreciable property between certain related taxpayers after October 4, 1976.

(a) *In general*. In the case of a sale or exchange of property, directly or indirectly, between related persons after October 4, 1976 (other than a sale or exchange made under a binding contract entered into on or before that date), any gain recognized by the transferor shall be treated as ordinary income if such property is, in the hands of the transferee, subject to the allowance for depreciation provided in section 167. This rule also applies to property which would be subject to the allowance for depreciation provided in section 167 except that the purchaser has elected a different form of deduction, such as those allowed under sections 169, 188, and 191.

(b) *Related persons*. For purposes of paragraph (a) of this section, the term *related persons* means:

(1) A husband and wife,

(2) An individual and a corporation 80 percent or more in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual, or

(3) Two or more corporations 80 percent or more in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual.

(c) *Rules of construction*—(1) *Husband and wife*. For purposes of paragraph (b)(1) of this section, if on the date of the sale or exchange a taxpayer is legally separated from his spouse under an interlocutory decree of divorce, the taxpayer and his spouse shall not be treated as husband and wife, provided the sale or exchange is made pursuant to the decree and the decree subsequently becomes final. Thus, if pursuant to an interlocutory decree of divorce, an individual transfers depreciable property to his spouse and, because of this section, the gain recognized on the transfer of the property is treated as ordinary income, the individual may, if the interlocutory decree becomes final after his tax return has been filed, file a claim for a refund.

(2) *Sales between commonly controlled corporations*. In general, in the case of a sale or exchange of depreciable property between related corporations (within the meaning of paragraph (b)(3) of this section), gain which is treated as ordinary income by reason of this section shall be taxable to the transferor corporation rather than to a controlling shareholder. However, such gain shall be treated as ordinary income taxable to a controlling shareholder rather than the transferor corporation if the transferor corporation is used by a controlling shareholder as a mere conduit to make a sale to another controlled corporation, or the entity of the corporate transferor is otherwise properly disregarded for tax purposes. Sales between two or more corporations that are related within the meaning of paragraph (b)(3) of this section may also be subject to the rules of section 482 (relating to allocation of income between or among organizations, trades, or businesses which are commonly owned or controlled), and to rules requiring constructive dividend treatment to the controlling shareholder in appropriate circumstances.

(3) *Relationship determination for transfers made after January 6, 1983—taxpayer and an 80-percent owned entity*. For purposes of paragraph (b)(2) of this section with respect to transfers made after January 6, 1983—

(i) If the transferor is an entity, the transferee and such entity are related

if the entity is an 80-percent owned entity with respect to such transferee either immediately before or immediately after the sale or exchange of depreciable property, and

(ii) If the transferor is not an entity, the transferee and such transferor are related if the transferee is an 80-percent owned entity with respect to such transferor immediately after the sale or exchange of depreciable property.

(4) *Relationship determination for transfers made after January 6, 1983—two 80-percent owned entities.* For purposes of paragraph (b)(3) of this section, with respect to transfers made after January 6, 1983, two entities are related if the same shareholder both owns 80 percent or more in value of the stock of the transferor before the sale or exchange of depreciable property and owns 80 percent or more in value of the stock of the transferee immediately after the sale or exchange of depreciable property.

(5) *Ownership of stock.* For purposes of determining the ownership of stock under this section, the constructive ownership rules of section 318 shall be applied, except that section 318(a)(2)(C) (relating to attribution of stock ownership from a corporation) and section 318(a)(3)(C) (relating to attribution of stock ownership to a corporation) shall be applied without regard to the 50-percent limitation contained therein. The application of the constructive ownership rules of section 318 to section 1239 is illustrated by the following examples:

Example 1. A, an individual, owns 79 percent of the stock (by value) of Corporation X, and a trust for A's children owns the remaining 21 percent of the stock. A's children are deemed to own the stock owned for their benefit by the trust in proportion to their actuarial interests in the trust (section 318(a)(2)(B)). A, in turn, constructively owns the stock so deemed to be owned by his children (section 318(a)(1)(A)(ii)). Thus, A is treated as owning all the stock of Corporation X, and any gain A recognizes from the sale of depreciable property to Corporation X is treated under section 1239 as ordinary income.

Example 2. Y Corporation owns 100 percent in value of the stock of Z Corporation. Y Corporation sells depreciable property at a gain to Z Corporation. P and his daughter, D, own 80 percent in value of the Y Corporation stock. Under the constructive ownership rules of section 318, as applied to section 1239, P and D are each considered to own the stock in Z Corporation owned by Y Corporation. Also, P and D are each considered to own the stock in Y Corporation owned by the other. As a result, both P and D constructively own 80 percent or more in value of the stock of both Y and Z Corporations. Thus, the sale between Y and Z is governed by section 1239 and produces ordinary income to Y.

[T.D. 7569, 43 FR 51388, Nov. 3, 1978, as amended by T.D. 8106, 51 FR 42835, Nov. 26, 1986]

§ 1.1239–2 Gain from sale or exchange of depreciable property between certain related taxpayers on or before October 4, 1976.

Section 1239 provides in general that any gain from the sale or exchange of depreciable property between a husband and wife or between an individual and a controlled corporation on or before October 4, 1976 (and in the case of a sale or exchange occurring after that date if made under a binding contract entered into on or before that date), shall be treated as ordinary income. Thus, any gain recognized to the transferor from a sale or exchange after May 3, 1951, and on or before October 4, 1976 (or thereafter if pursuant to a binding contract entered into on or before that date), directly or indirectly, between a husband and wife or between an individual and a controlled corporation, of property which, in the hands of the transferee, is property of a character subject to an allowance for depreciation provided in section 167 (including such property on which a deduction for amortization is allowable under sections 168 and 169) shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. For the purpose of section 1239, a corporation is controlled when more than 80 percent in value of all outstanding stock of the corporation is beneficially owned by the taxpayer, his spouse, and his minor children and minor grandchildren. For the purpose of this section, the terms *children* and *grandchildren* include legally adopted children and their children. The provisions of section 1239(a)(2) are applicable whether property is transferred from a

corporation to a shareholder or from a shareholder to a corporation.

[T.D. 6500, 25 FR 12021, Nov. 26, 1960, as amended by T.D. 7569, 43 FR 51388, Nov. 3, 1978]

§ 1.1240–1 Capital gains treatment of certain termination payments.

Any amounts received by an employee for the assignment or release of all his rights to receive, after termination of his employment and for a period of not less than five years or for a period ending with his death, a percentage of the profits or receipts of his employer attributable to a time subsequent to such termination, are considered received from the sale or exchange of a capital asset held for more than six months if the following requirements are met:

(a) The employee was employed by the employer, in whose future profits or receipts the employee had an interest, for a period of more than 20 years before the assignment or release by the employee of his rights in such future profits or receipts,

(b) The full rights of the employee to the percentage of the future profits or receipts on such employer, which rights are the subject of the assignment or release, were incorporated in the terms of the contract of employment between the employee and the employer for a period of at least 12 years, and were so incorporated before August 16, 1954,

(c) The assignment or release was made after the termination of the employee's employment with such employer,

(d) The assignment or release conveyed all the rights of the employee in the future profits or receipts of such employer and conveyed no other rights of the employee, and

(e) The total amount to which the employee became entitled pursuant to the assignment or release was received by the employee after the termination of his employment with such employer and in one taxable year of the employee.

The requirement that the assignment or release be made after the termination of the employee's employment contemplates a complete and bona fide termination of the relationship of employer and employee. This requires more than a mere termination of such relationship under the particular contract or contracts of employment pursuant to which the employee acquired his rights in the future profits or receipts of the employer. The contract need not expressly provide that the employee shall share in the future profits or receipts of the employer for a minimum period of five years. However, if the contract does not expressly so provide and the assignment or release is made before the expiration of five years following the termination of employment, the terms of the contract considered in conjunction with the facts in the particular situation must establish that the rights of the employee to a percentage of future profits or receipts, in all probability, will extend to a period of not less than five years from the date of termination of employment or for a period ending with his death. Section 1240 has application only to an assignment or release made by the employee who acquired the right to a percentage of future profits or receipts of the employer, and has no application to amounts received other than as payment for assignment or release of such right. Section 1240 has no effect upon the determination of the income tax of the employer making the payment to the employee.

[T.D. 6500, 25 FR 12021, Nov. 26, 1960]

§ 1.1241–1 Cancellation of lease or distributor's agreement.

(a) *In general.* Section 1241 provides that proceeds received by lessees or distributors from the cancellation of leases or of certain distributorship agreements are considered as amounts received in exchange therefor. Section 1241 applies to leases of both real and personal property. Distributorship agreements to which section 1241 applies are described in paragraph (c) of this section. Section 1241 has no application in determining whether or not a cancellation not qualifying under that section is a sale or exchange. Further, section 1241 has no application in determining whether or not a lease or a distributorship agreement is a capital asset, even though its cancellation qualifies as an exchange under section 1241.

(b) *Definition of cancellation.* The term *cancellation* of a lease or a distributor's agreement, as used in section 1241, means a termination of all the contractual rights of a lessee or distributor with respect to particular premises or a particular distributorship, other than by the expiration of the lease or agreement in accordance with its terms. A payment made in good faith for a partial cancellation of a lease or a distributorship agreement is recognized as an amount received for cancellation under section 1241 if the cancellation relates to a severable economic unit, such as a portion of the premises covered by a lease, a reduction in the unexpired term of a lease or distributorship agreement, or a distributorship in one of several areas or of one of several products. Payments made for other modifications of leases or distributorship agreements, however, are not recognized as amounts received for cancellation under section 1241.

(c) *Amounts received upon cancellation of a distributorship agreement.* Section 1241 applies to distributorship agreements only if they are for marketing or marketing and servicing of goods. It does not apply to agreements for selling intangible property or for rendering personal services as, for example, agreements establishing insurance agencies or agencies for the brokerage of securities. Further, it applies to a distributorship agreement only if the distributor has made a substantial investment of capital in the distributorship. The substantial capital investment must be reflected in physical assets such as inventories of tangible goods, equipment, machinery, storage facilities, or similar property. An investment is not considered substantial for purposes of section 1241 unless it consists of a significant fraction or more of the facilities for storing, transporting, processing, or otherwise dealing with the goods distributed, or consists of a substantial inventory of such goods. The investment required in the maintenance of an office merely for clerical operations is not considered substantial for purposes of this section. Furthermore, section 1241 shall not apply unless a substantial amount of the capital or assets needed for carrying on the operations of a distributorship are acquired by the distributor and actually used in carrying on the distributorship at some time before the cancellation of the distributorship agreement. It is immaterial for the purposes of section 1241 whether the distributor acquired the assets used in performing the functions of the distributorship before or after beginning his operations under the distributorship agreement. It is also immaterial whether the distributor is a retailer, wholesaler, jobber, or other type of distributor. The application of this paragraph may be illustrated by the following examples:

Example 1. Taxpayer is a distributor of various food products. He leases a warehouse including cold storage facilities and owns a number of motor trucks. In 1955 he obtains the exclusive rights to market certain frozen food products in his State. The marketing is accomplished by using the warehouse and trucks acquired before he entered into the agreement and entails no additional capital. Payments received upon the cancellation of the agreement are treated under section 1241 as though received upon the sale or exchange of the agreement.

Example 2. Assume that the taxpayer in example (1) entered into an exclusive distributorship agreement with the producer under which the taxpayer merely solicits orders through his staff of salesmen, the goods being shipped direct to the purchasers. Payments received upon the cancellation of the agreement would not be treated under section 1241 as though received upon the sale or exchange of the agreement.

Example 3. Taxpayer is an exclusive distributor for M city of certain frozen food products which he distributes to frozen-food freezer and locker customers. The terms of his distributorship do not make it necessary for him to have any substantial investment in inventory. Taxpayer rents a loading platform for a nominal amount, but has no warehouse space. Orders for goods from customers are consolidated by the taxpayer and forwarded to the producer from time to time. Upon receipt of these goods, taxpayer allocates them to the individual orders of customers and delivers them immediately by truck. Although it would require a fleet of fifteen or twenty trucks to carry out this operation, the distributor uses only one truck of his own and hires cartage companies to deliver the bulk of the merchandise to the customers. Payments received upon the cancellation of the distributorship agreement in such a case would not be considered received upon the sale or exchange of the agreement under section 1241 since the taxpayer does not have facilities for the physical handling

of more than a small fraction of the goods involved in carrying on the distributorship and, therefore, does not have a substantial capital investment in the distributorship. On the other hand, if the taxpayer had acquired and used a substantial number of the trucks necessary for the deliveries to his customers, payments received upon the cancellation of the agreement would be considered received in exchange therefor under section 1241.

[T.D. 6500, 25 FR 12021, Nov. 26, 1960]

§ 1.1242–1 Losses on small business investment company stock.

(a) *In general.* Any taxpayer who sustains a loss for a taxable year beginning after September 2, 1958, as a result of the worthlessness, or from the sale or exchange, of the stock of a small business investment company (whether or not such stock was originally issued to such taxpayer) shall treat such loss as a loss from the sale or exchange of property which is not a capital asset, if at the time of such loss:

(1) The company which issued the stock is licensed to operate as a small business investment company pursuant to regulations promulgated by the Small Business Administration (13 CFR part 107), and

(2) Such loss would, but for the provisions of section 1242, be a loss from the sale or exchange of a capital asset.

(b) *Treatment of losses for purposes of section 172.* For the purposes of section 172 (relating to the net operating loss deduction), any amount of loss treated by reason of section 1242 as a loss from the sale or exchange of property which is not a capital asset shall be treated as attributable to the trade or business of the taxpayer. Accordingly, the limitation of section 172(d)(4) on the allowance of nonbusiness deductions in computing a net operating loss shall not apply to any loss with respect to the stock of a small business investment company as described in paragraph (a) of this section. See section 172(d) and § 1.172–3.

(c) *Statement to be filed with return.* A taxpayer claiming a deduction for a loss on the stock of a small business investment company shall file with his income tax return a statement containing: The name and address of the small business investment company which issued the stock, the number of shares, basis, and selling price of the stock with respect to which the loss is claimed, the respective dates of purchase and sale of such stock, or the reason for its worthlessness and approximate date thereof. For the rules applicable in determining the worthlessness of securities, see section 165 and the regulations thereunder.

[T.D. 6500, 25 FR 12022, Nov. 26, 1960]

§ 1.1243–1 Loss of small business investment company.

(a) *In general*—(1) *Taxable years beginning after July 11, 1969.* For taxable years beginning after July 11, 1969, a small business investment company to which section 582(c) applies, and which sustains a loss as a result of the worthlessness, or on the sale or exchange, of the stock of a small business concern (as defined in section 103(5) of the Small Business Investment Act of 1958, as amended (15 U.S.C. 662(5)) and in 13 CFR 107.3), shall treat such loss as a loss from the sale or exchange of property which is not a capital asset if:

(i) The stock was issued pursuant to the conversion privilege of the convertible debentures acquired in accordance with the provisions of section 304 of the Small Business Investment Act of 1958 (15 U.S.C. 684) and the regulations thereunder.

(ii) Such loss would, but for the provisions of section 1243, be a loss from the sale or exchange of a capital asset, and

(iii) At the time of the loss, the company is licensed to operate as a small business investment company pursuant to regulations promulgated by the Small Business Administration (13 CFR part 107).

If section 582(c) does not apply for the taxable year, see subparagraph (2) of this paragraph.

(2) *Taxable years beginning before July 11, 1974.* For taxable years beginning after September 2, 1958, but before July 11, 1974, a small business investment company to which section 582(c) does not apply, and which sustains a loss as a result of the worthlessness, or on the sale or exchange, of the securities of a small business concern (as defined in section 103(5) of the Small Business Investment Act of 1958, as amended (15 U.S.C. 662(5)) and in 13 CFR 107.3), shall treat such loss as a loss from the sale

or exchange of property which is not a capital asset if:

(i) The securities are either the convertible debentures, or the stock issued pursuant to the conversion privilege thereof, acquired in accordance with the provisions of section 304 of the Small Business Investment Act of 1958 (15 U.S.C. 684) and the regulations thereunder.

(ii) Such loss would, but for the provisions of this subparagraph, be a loss from the sale or exchange of a capital asset, and

(iii) At the time of the loss, the company is licensed to operate as a small business investment company pursuant to regulations promulgated by the Small Business Administration (13 CFR part 107).

If section 582(c) applies for the taxable year, see subparagraph (1) of this paragraph.

(b) *Material to be filed with return.* A small business investment company which claims a deduction for a loss on the convertible debentures (pursuant to paragraph (a)(2) of this section) or stock (pursuant to paragraph (a) (1) or (2) of this section) of a small business concern shall submit with its income tax return a statement that it is a Federal licensee under the Small Business Investment Act of 1958 (15 U.S.C. chapter 14B). The statement shall also set forth: the name and address of the small business concern with respect to whose securities the loss was sustained, the number of shares of stock or the number and denomination of debentures with respect to which the loss is claimed, the basis and selling price thereof, and the respective dates of purchase and sale of the securities, or the reason for their worthlessness and the approximate date thereof. For the rules applicable in determining the worthlessness of securities, see section 165 and the regulations thereunder.

[T.D. 7171, 37 FR 5621, Mar. 17, 1972]

§ 1.1244(a)–1 Loss on small business stock treated as ordinary loss.

(a) *In general.* Subject to certain conditions and limitations, section 1244 provides that a loss on the sale or exchange (including a transaction treated as a sale or exchange, such as worthlessness) of *section 1244 stock* which would otherwise be treated as a loss from the sale or exchange of a capital asset shall be treated as a loss from the sale or exchange of an asset which is not a capital asset (referred to in this section and §§ 1.1244(b)–1 to 1.1244(e)–1, inclusive, as an *ordinary loss*). Such a loss shall be allowed as a deduction from gross income in arriving at adjusted gross income. The requirements that must be satisfied in order that stock may be considered section 1244 stock are described in §§ 1.1244(c)–1 and 1.1244(c)–2. These requirements relate to the stock itself and the corporation issuing such stock. In addition, the taxpayer who claims an ordinary loss deduction pursuant to section 1244 must satisfy the requirements of paragraph (b) of this section.

(b) *Taxpayers entitled to ordinary loss.* The allowance of an ordinary loss deduction for a loss of section 1244 stock is permitted only to the following two classes of taxpayers:

(1) An individual sustaining the loss to whom the stock was issued by a small business corporation, or

(2) An individual who is a partner in a partnership at the time the partnership acquired the stock in an issuance from a small business corporation and whose distributive share of partnership items reflects the loss sustained by the partnership. The ordinary loss deduction is limited to the lesser of the partner's distributive share at the time of the issuance of the stock or the partner's distributive share at the time the loss is sustained. In order to claim a deduction under section 1244 the individual, or the partnership, sustaining the loss must have continuously held the stock from the date of issuance. A corporation, trust, or estate is not entitled to ordinary loss treatment under section 1244 regardless of how the stock was acquired. An individual who acquires stock from a shareholder by purchase, gift, devise, or in any other manner is not entitled to an ordinary loss under section 1244 with respect to this stock.

Thus, ordinary loss treatment is not available to a partner to whom the stock is distributed by the partnership. Stock acquired through an investment

banking firm, or other person, participating in the sale of an issue may qualify for ordinary loss treatment only if the stock is not first issued to the firm or person. Thus, for example, if the firm acts as a selling agent for the issuing corporation the stock may qualify. On the other hand, stock purchased by an investment firm and subsequently resold does not qualify as section 1244 stock in the hands of the person acquiring the stock from the firm.

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

Example 1. A and B, both individuals, and C, a trust, are equal partners in a partnership to which a small business corporation issues section 1244 stock. The partnership sells the stock at a loss. A's and B's distributive share of the loss may be treated as an ordinary loss pursuant to section 1244, but C's distributive share of the loss may not be so treated.

Example 2. The facts are the same as in example (1) except that the section 1244 stock is distributed by the partnership to partner A and he subsequently sells the stock at a loss. Section 1244 is not applicable to the loss since A did not acquire the stock by issuance from the small business corporation.

[T.D. 6495, 25 FR 9675, Oct. 8, 1960, as amended by T.D. 7779, 46 FR 29467, June 2, 1981]

§ 1.1244(b)–1 Annual limitation.

(a) *In general*. Subsection (b) of section 1244 imposes a limitation on the aggregate amount of loss that for any taxable year may be treated as an ordinary loss by a taxpayer by reason of that section. In the case of a partnership, the limitation is determined separately as to each partner. Any amount of loss in excess of the applicable limitation is treated as loss from the sale or exchange of a capital asset.

(b) *Amount of loss*—(1) *Taxable years beginning after December 31, 1978*. For any taxable year beginning after December 31, 1978, the maximum amount that may be treated as an ordinary loss under section 1244 is:

(i) $50,000, or

(ii) $100,000, if a husband and wife file a joint return under section 6013.

These limitations on the maximum amount of ordinary loss apply whether the loss or losses are sustained on pre-November 1978 stock (as defined in § 1.1244 (c)–1 (a)(1)), post-November 1978 stock (as defined in § 1.1244 (c)–1 (a)(2)), or on any combination of pre-November 1978 stock and post-November 1978 stock. The limitation referred to in (ii) applies to a joint return whether the loss or losses are sustained by one or both spouses.

(2) *Taxable years ending before November 6, 1978*. For any taxable year ending before November 6, 1978, the maximum amount that may be treated as an ordinary loss under section 1244 is:

(i) $25,000 or

(ii) $50,000, if a husband and wife file a joint return under section 6013.

The limitation referred to in (ii) applies to a joint return whether the loss or losses are sustained by one or both spouses.

(3) *Taxable years including November 6, 1978*. For a taxable year including November 6, 1978, the maximum amount that may be treated as ordinary loss under section 1244 is the sum of:

(i) The amount calculated by applying the limitations described in subparagraph (1) of this paragraph (b) to the amount of loss, if any, sustained during the taxable year on post-November 1978 stock, plus

(ii) The amount calculated by applying the limitations described in subparagraph (2) of this paragraph (b) to the amount of loss, if any, sustained during the taxable year on pre-November 1978 stock,

To the extent this sum does not exceed $50,000, or, if a husband and wife file a joint return under section 6013 for the taxable year, $100,000.

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

Example 1. A, a married taxpayer who files a joint return for the taxable year ending December 31, 1977, sustains a $50,000 loss qualifying under section 1244 on pre-November 1978 stock in Corporation X and an equal amount of loss qualifying under section 1244 on pre-November 1978 stock in Corporation Y. A is limited to $50,000 of ordinary loss under paragraph (b)(2)(ii). The remaining $50,000 of loss is treated as loss from the sale or exchange of a capital asset.

Example 2. For the taxable year ending December 31, 1979, B, a married taxpayer who files a joint return, sustains a $90,000 loss on post-November 1978 stock in Corporation X.

In the same taxable year, C, B's spouse, sustains a $25,000 loss on post-November 1978 stock in Corporation Y. Both losses qualify under section 1244. B and C's ordinary loss is limited to $100,000 under paragraph (b)(1)(ii). The remaining $15,000 of loss is treated as loss from the sale or exchange of a capital asset.

Example 3. D, a married taxpayer who files a joint return and reports income on a fiscal year basis for the taxable year ending November 30, 1978, sustains a $60,000 loss qualifying under section 1244 on pre-November 1978 stock and a $40,000 loss qualifying under section 1244 on post-November 1978 stock. D's ordinary loss on pre-November 1978 stock is limited to $50,000 under subparagraph (3)(ii) of this paragraph (b). D's $40,000 loss on post-November 1978 stock is within the limit of subparagraph (3)(i) of this paragraph (b). The total of these losses, $90,000, is the aggregate amount deductible by D as ordinary loss under section 1244. The remaining $10,000 of loss is treated as loss from the sale or exchange of a capital asset.

Example 4. E, a married taxpayer who files a joint return for the taxable year ending December 31, 1980, sustains a $75,000 loss qualifying under section 1244 on pre-November 1978 stock and a $10,000 loss qualifying under section 1244 on post-November 1978 stock. E may deduct the total of these losses, $85,000, as ordinary loss under paragraph (b)(1)(ii).

Example 5. Assume the same facts as in the preceding example, except that the losses are sustained in the taxable year beginning January 1, 1978, and ending December 31, 1978. E is limited to $60,000 of ordinary loss ($50,000 on pre-November 1978 stock plus $10,000 on post-November 1978 stock) under paragraph (b)(3). The remaining $25,000 of loss is treated as loss from the sale or exchange of a capital asset.

Example 6. F, a married taxpayer who files a joint return for the taxable year beginning January 1, 1978, and ending December 31, 1978, sustains a $75,000 loss qualifying under section 1244 on pre-November 1978 stock and a $125,000 loss qualifying under section 1244 on post-November 1978 stock. F's loss on pre-November 1978 stock is limited to $50,000 of ordinary loss under subparagraph (3)(ii) of this paragraph (b). F's loss on post-November 1978 stock is limited to $100,000 of ordinary loss under subparagraph (3)(i) of this paragraph (b). The total of these losses, $150,000, is limited to $100,000 of ordinary loss under paragraph (b)(3). F's aggregate amount of ordinary loss under section 1244 is $100,000. The remaining $100,000 of loss is treated as loss from the sale or exchange of a capital asset.

[T.D. 7779, 46 FR 29467, June 2, 1981]

§ 1.1244(c)–1 Section 1244 stock defined.

(a) *In general.* For purposes of §§ 1.1244(a)–1 to 1.1244(e)–1, inclusive:

(1) The term *pre-November 1978 stock* means stock issued after June 30, 1958, and on or before November 6, 1978.

(2) The term *post-November 1978 stock* means stock issued after November 6, 1978.

In order that stock may qualify as section 1244 stock, the requirements described in paragraphs (b) through (e) of this section must be satisfied. In addition, the requirements of paragraph (f) of this section must be satisfied in the case of pre-November 1978 stock. Whether these requirements have been met is determined at the time the stock is issued, except for the requirement in paragraph (e) of this section. Whether the requirement in paragraph (e) of this section, relating to gross receipts of the corporation, has been satisfied is determined at the time a loss is sustained. Therefore, at the time of issuance it cannot be said with certainty that stock will qualify for the benefits of section 1244.

(b) *Common stock.* Only common stock, either voting or nonvoting, in a domestic corporation may qualify as section 1244 stock. For purposes of section 1244, neither securities of the corporation convertible into common stock nor common stock convertible into other securities of the corporation are treated as common stock. An increase in the basis of outstanding stock as a result of a contribution to capital is not treated as an issuance of stock under section 1244. For definition of domestic corporation, see section 7701(a)(4) and the regulations under that section.

(c) *Small business corporation.* At the time the stock is issued (or, in the case of pre-November 1978 stock, at the time of adoption of the plan described in paragraph (f)(1) of this section) the corporation must be a *small business corporation.* See § 1.1244(c)–2 for the definition of a small business corporation.

(d) *Issued for money or other property.* (1) The stock must be issued to the taxpayer for money or other property transferred by the taxpayer to the corporation. However, stock issued in exchange for stock or securities, including stock or securities of the issuing corporation, cannot qualify as section 1244 stock, except as provided in

§ 1.1244(d)–3, relating to certain cases where stock is issued in exchange for section 1244 stock. Stock issued for services rendered or to be rendered to, or for the benefit of, the issuing corporation does not qualify as section 1244 stock. Stock issued in consideration for cancellation of indebtedness of the corporation shall be considered issued in exchange for money or other property unless such indebtedness is evidenced by a security, or arises out of the performance of personal services.

(2) The following examples illustrate situations where stock fails to qualify as section 1244 stock as a result of the rules in subparagraph (1) of this paragraph:

Example 1. A taxpayer owns stock of Corporation X issued to him prior to July 1, 1958. Under a plan adopted in 1977, he exchanges his stock for a new issuance of stock of Corporation X. The stock received by the taxpayer in the exchange may not qualify as section 1244 stock even if the corporation has adopted a valid plan and is a small business corporation.

Example 2. A taxpayer owns stock in Corporation X. Corporation X merges into Corporation Y. In exchange for his stock, Corporation Y issues shares of its stock to the taxpayer. The stock in Corporation Y does not qualify as section 1244 stock even if the stock exchanged by the taxpayer did qualify.

Example 3. Corporation X transfers part of its business assets to Corporation Y, a new corporation, and all of the stock of Corporation Y is issued directly to the shareholders of Corporation X. Since the Corporation Y stock was not issued to the shareholders for a transfer by them of money or other property, none of the Corporation Y stock in the hands of the shareholders can qualify.

(e) *Gross receipts.* (1)(i)(*a*) Except as provided in subparagraph (2) of this paragraph, stock will not qualify under section 1244, if 50 percent or more of the gross receipts of the corporation, for the period consisting of the five most recent taxable years of the corporation ending before the date the loss on such stock is sustained by the shareholders, is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. If the corporation has not been in existence for five taxable years ending before such date, the percentage test referred to in the preceding sentence applies to the period of the taxable years ending before such date during which the corporation has been in existence; and if the loss is sustained during the first taxable year of the corporation such test applies to the period beginning with the first day of such taxable year and ending on the day before the loss is sustained. The test under this paragraph shall be made on the basis of total gross receipts, except that gross receipts from the sales or exchanges of stock or securities shall be taken into account only to the extent of gains therefrom. The term *gross receipts* as used in section 1244(c)(1)(C) is not synonymous with *gross income*. Gross receipts means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income. Thus, the total amount of receipts is not reduced by returns and allowances, cost, or deductions. For example, gross receipts will include the total amount received or accrued during the corporation's taxable year from the sale or exchange (including a sale or exchange to which section 337 applies) of any kind of property, from investments, and for services rendered by the corporation. However, gross receipts does not include amounts received in nontaxable sales or exchanges (other than those to which section 337 applies), except to the extent that gain is recognized by the corporation, nor does that term include amounts received as a loan, as a repayment of a loan, as a contribution to capital, or on the issuance by the corporation of its own stock.

(*b*) The meaning of the term *gross receipts* as used in section 1244(c)(1)(C) may be further illustrated by the following examples:

Example 1. A corporation on the accrual method sells property (other than stock or securities) and receives payment partly in money and partly in the form of a note payable at a future time. The amount of the money and the face amount of the note would be considered gross receipts in the taxable year of the sale and would not be reduced by the adjusted basis of the property, the costs of sale, or any other amount.

Example 2. A corporation has a long-term contract as defined in paragraph (a) of § 1.451–3 with respect to which it reports income according to the percentage-of-completion method as described in paragraph (b)(1) of § 1.451–3. The portion of the gross contract price which corresponds to the percentage of

the entire contract which has been completed during the taxable year shall be included in gross receipts for such year.

Example 3. A corporation which regularly sells personal property on the installment plan elects to report its taxable income from the sale of property (other than stock or securities) on the installment method in accordance with section 453. The installment payments actually received in a given taxable year of the corporation shall be included in gross receipts for such year.

(ii) The term *royalties* as used in subdivision (i) of this subparagraph means all royalties, including mineral, oil, and gas royalties (whether or not the aggregate amount of such royalties constitutes 50 percent or more of the gross income of the corporation for the taxable year), and amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property. The term *royalties* does not include amounts received upon the disposal of timber, coal, or domestic iron ore with a retained economic interest to which the special rules of section 631 (b) and (c) apply or amounts received from the transfer of patent rights to which section 1235 applies. For the definition of *mineral, oil, or gas royalties*, see paragraph (b)(11) (ii) and (iii) of §1.543–1. For purposes of this subdivision, the gross amount of royalties shall not be reduced by any part of the cost of the rights under which they are received or by any amount allowable as a deduction in computing taxable income.

(iii) The term *rents* as used in subdivision (i) of this subparagraph means amounts received for the use of, or right to use, property (whether real or personal) of the corporation, whether or not such amounts constitute 50 percent or more of the gross income of the corporation for the taxable year. The term *rents* does not include payments for the use or occupancy of rooms or other space where significant services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist homes, motor courts, or motels. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such services; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in an office building, etc., are generally *rents* under section 1244(c)(1)(C). Payments for the parking of automobiles ordinarily do not constitute rents. Payments for the warehousing of goods or for the use of personal property do not constitute rents if significant services are rendered in connection with such payments.

(iv) The term *dividends* as used in subdivision (i) of this subparagraph includes dividends as defined in section 316, amounts required to be included in gross income under section 551 (relating to foreign personal holding company income taxed to United States shareholders), and consent dividends determined as provided in section 565.

(v) The term *interest* as used in subdivision (i) of this subparagraph means any amounts received for the use of money (including tax-exempt interest).

(vi) The term *annuities* as used in subdivision (i) of this subparagraph means the entire amount received as an annuity under an annuity, endowment, or life insurance contract, regardless of whether only part of such amount would be includible in gross income under section 72.

(vii) For purposes of subdivision (i) of this subparagraph, gross receipts from the sales or exchanges of stock or securities are taken into account only to the extent of gains therefrom. Thus, the gross receipts from the sale of a particular share of stock will be the excess of the amount realized over the adjusted basis of such share. If the adjusted basis should equal or exceed the amount realized on the sale or exchange of a certain share of stock, bond, etc., there would be no gross receipts resulting from the sale of such security. Losses on sales or exchanges

of stock or securities do not offset gains on the sales or exchanges of other stock or securities for purposes of computing gross receipts from such sales or exchanges. Gross receipts from the sale or exchange of stocks and securities include gains received from such sales or exchanges by a corporation even though such corporation is a regular dealer in stocks and securities. For the meaning of the term *stocks or securities,* see paragraph (b)(5)(i) of § 1.543–1.

(2) The requirement of subparagraph (1) of this paragraph need not be satisfied if for the applicable period the aggregate amount of deductions allowed to the corporation exceeds the aggregate amount of its gross income. But for this purpose the deductions allowed by section 172, relating to the net operating loss deduction, and by sections 242, 243, 244, and 245, relating to certain special deductions for corporations, shall not be taken into account. Notwithstanding the provisions of this subparagraph and of subparagraph (1) of this paragraph, pursuant to the specific delegation of authority granted in section 1244(e) to prescribe such regulations as may be necessary to carry out the purposes of section 1244, ordinary loss treatment will not be available with respect to stock of a corporation which is not largely an operating company within the five most recent taxable years (or such lesser period as the corporation is in existence) ending before the date of the loss. Thus, for example, assume that a person who is not a dealer in real estate forms a corporation which issues stock to him which meets all the formal requirements of section 1244 stock. The corporation then acquires a piece of unimproved real estate which it holds as an investment. The property declines in value and the stockholder sells his stock at a loss. The loss does not qualify for ordinary loss treatment under section 1244 but must be treated as a capital loss.

(3) In applying subparagraphs (1) and (2) of this paragraph to a successor corporation in a reorganization described in section 368(a)(1)(F), such corporation shall be treated as the same corporation as its predecessor. See paragraph (d)(2) of § 1.1244(d)–3.

(f) *Special rules applicable to pre-November 1978 stock.* (1)(i) Pre-November 1978 common stock must have been issued under a written plan adopted by the corporation after June 30, 1958, and on or before November 6, 1978, to offer only this stock during a period specified in the plan ending not later than 2 years after the date the plan is adopted. The 2-year requirement referred to in the preceding sentence is met if the period specified in the plan is based upon the date when, under the rules or regulations of a Government agency relating to the issuance of the stock, the stock may lawfully be sold, and it is clear that this period will end, and in fact does end, within 2 years after the plan is adopted. The plan must specifically state, in terms of dollars, the maximum amount to be received by the corporation in consideration for the stock to be issued under the plan. See § 1.1244(c)–2 for the limitation on the amount that may be received by the corporation under the plan.

(ii) To qualify, the pre-November 1978 stock must be issued during the period of the offer, which period must end not later than two years after the date the plan is adopted. Pre-November 1978 stock which is subscribed for during the period of the plan but not issued during this period cannot qualify as section 1244 stock. Pre-November 1978 stock issued on the exercise of a stock right, stock warrant, or stock option (which right, warrant, or option was not outstanding at the time the plan was adopted) will be treated as issued under a plan only if the right, warrant, or option is applicable solely to unissued stock offered under the plan and is exercised during the period of the plan.

(iii) Pre-November 1978 stock subscribed for prior to the adoption of the plan, including stock subscribed for prior to the date the corporation comes into existence, may be considered issued under a plan adopted by the corporation if the stock is not in fact issued prior to the adoption of the plan.

(iv) Pre-November 1978 stock issued for a payment which, alone or together with prior payments, exceeds the maximum amount that may be received under the plan, is not considered issued

under the plan, and none of the stock can qualify as section 1244 stock. See § 1.1244(c)–2(b) for a different rule with respect to post-November 1978 stock.

(2) Pre-November 1978 stock does not qualify as section 1244 stock if at the time of the adoption of the plan under which it is issued there remains unissued any portion of a prior offering of stock. Thus, if any portion of an outstanding offering of common or preferred stock is unissued at the time of the adoption of the plan, stock issued under the plan will not qualify as section 1244 stock. An offer is outstanding unless and until it is withdrawn by affirmative action before the plan is adopted. Stock rights, stock warrants, stock options, or securities convertible into stock, that are outstanding at the time the plan is adopted, are considered prior offerings. The authorization in the corporate charter to issue stock different from stock offered under the plan or in excess of stock offered under the plan is not of itself a prior offering.

(3)(i) Even though the plan satisfies the requirements of subparagraph (1) of this paragraph (f), if another offering of pre-November 1978 stock is made by the corporation subsequent to, or simultaneous with, the adoption of the plan, pre-November 1978 stock issued under the plan after the other offering does not qualify as section 1244 stock. The issuance of stock options, stock rights, or stock warrants at any time during the period of the plan, that are exercisable on stock other than stock offered under the plan, is considered a subsequent offering. Similarly, the issuance of pre-November 1978 stock other than that offered under the plan is considered a subsequent offering. Because stock issued upon exercise of a converson privilege is stock issued for a security, and stock issued under a stock option granted in whole or in part for services is not issued for money or other property, the issuance of securities with a conversion privilege and the issuance of such a stock option are subsequent offerings, because the conversion privilege and the stock option are exercisable with respect to stock other than that which may properly be offered under the plan. Pre-November 1978 stock issued under the plan before a subsequent offering is not disqualified because of the subsequent offering. The rule of the subparagraph, together with the rule of subparagraph (2) of this paragraph (f), relating to offers prior to the adoption of the plan, limits pre-November 1978 section 1244 stock to stock issued by the corporation during a period when any stock issued by it must have been issued under the plan.

(ii) Any modification of a plan that changes the offering to include preferred stock, or that increases the amount of pre-November 1978 stock that may be issued under the plan to such an extent that the requirements of paragraph (c) of this section would not have been satisfied if determined with reference to this amount as of the date the plan was initially adopted, or that extends the period of time during which stock may be issued under the plan to more than 2 years from the date the plan was initially adopted, is considered a subsequent offering, and no stock issued after this offering may qualify. However, a corporation may withdraw a plan and adopt a new plan to issue stock. To determine whether stock issued under this new plan may qualify, this paragraph (f) must be applied with respect to the new plan as of the date of its adoption. For example, amounts received for stock under the prior plan must be taken into account in determining whether the statutory requirements relating to definition of small business corporation are satisfied. In applying the requirements of paragraph (c) of this section, reference should be made to equity capital as of the date the new plan is adopted. The same principles apply if the period of the initial plan expires and the corporation adopts a new plan.

[T.D. 7779, 46 FR 29468, June 2, 1981]

§ 1.1244(c)–2 Small business corporation defined.

(a) *In general.* A corporation is treated as a small business corporation if it is a domestic corporation that satisfies the requirements described in paragraph (b) or (c) of this section. The requirements of paragraph (b) of this section apply if a loss is sustained on post-November 1978 stock. The requirements of paragraph (c) of this section apply if a loss is sustained on pre-November

1978 stock. If losses are sustained on both pre-November 1978 stock and post-November 1978 stock in the same taxable year, the requirements of paragraph (b) of this section are applied to the corporation at the time of the issuance of the stock (as required by paragraph (b) in the case of a loss on post-November 1978 stock) in order to determine whether the loss on post-November 1978 stock qualifies as a section 1244 loss, and the requirements of paragraph (c) of this section are applied to the corporation at the time of the adoption of the plan (as required by paragraph (c) in the case of a loss on pre-November 1978 stock) in order to determine whether the loss on pre-November 1978 stock qualifies as a section 1244 loss. For definition of domestic corporation, see section 7701 (a)(4) and the regulations under that section.

(b) *Post-November 1978 stock*—(1) *Amount received by corporation for stock.* Capital receipts of a small business corporation may not exceed $1,000,000. For purposes of this paragraph the term *capital receipts* means the aggregate dollar amount received by the corporation for its stock, as a contribution to capital, and as paid-in surplus. If the $1,000,000 limitation is exceeded, the rules of subparagraph (2) of this paragraph (b) apply. In making these determinations, (i) property is taken into account at its adjusted basis to the corporation (for determining gain) as of the date received by the corporation, and (ii) this aggregate amount is reduced by the amount of any liability to which the property was subject and by the amount of any liability assumed by the corporation at the time the property was received. Capital receipts are not reduced by distributions to shareholders, even though the distributions may be capital distributions.

(2) *Requirement of designation in event $1,000,000 limitation exceeded.* (i) If capital receipts exceed $1,000,000, the corporation shall designate as section 1244 stock certain shares of post-November 1978 common stock issued for money or other property in the transitional year. For purposes of this paragraph, the term *transitional year* means the first taxable year in which capital receipts exceed $1,000,000 and in which the corporation issues stock. This designation shall be made in accordance with the rules of subdivision (iii) of this paragraph (b)(2). The amount received for designated stock shall not exceed $1,000,000 less amounts received—

(A) In exchange for stock in years prior to the transitional year;

(B) As contributions to capital in years prior to the transitional year; and

(C) As paid-in surplus in years prior to the transitional year.

(ii) Post-November 1978 common stock issued for money or other property before the transitional year qualifies as section 1244 stock without affirmative designation by the corporation. Post-November 1978 common stock issued after the transitional year does not qualify as section 1244 stock.

(iii) The corporation shall make the designation required by subdivision (i) of this paragraph (b)(2) not later than the 15th day of the third month following the close of the transitional year. However, in the case of post-November 1978 common stock issued on or before June 2, 1981 the corporation shall make the required designation by August 3, 1981 or by the 15th day of the 3rd month following the close of the transitional year, whichever is later. The designation shall be made by entering the numbers of the qualifying share certificates on the corporation's records. If the shares do not bear serial numbers or other identifying numbers or letters, or are not represented by share certificates, the corporation shall make an alternative designation in writing at the time of issuance, or, in the case of post-November 1978 common stock issued on or before June 2, 1981 by August 3, 1981. This alternative designation may be made in any manner sufficient to identify the shares qualifying for section 1244 treatment. If the corporation fails to make a designation by share certificate number or an alternative written designation as described, the rules of subparagraph (3) of this paragraph (b) apply.

(3) *Allocation of section 1244 benefit in event corporation fails to designate qualifying shares.* If a corporation issues

post-November 1978 stock in the transitional year and fails to designate certain shares of post-November 1978 common stock as section 1244 stock in accordance with the rules of subparagraph (2) of this paragraph (b), the following rules apply:

(i) Section 1244 treatment is extended to losses sustained on post-November 1978 common stock issued for money or other property in taxable years before the transitional year and is withheld from losses sustained on post-November 1978 stock issued in taxable years after the transitional year.

(ii) Post-1958 capital received before the transitional year is subtracted from $1,000,000.

(iii) Subject to the annual limitation described in §1.1244(b)–1, an ordinary loss on post-November 1978 common stock issued for money or other property in the transitional year is allowed in an amount which bears the same ratio to the total loss sustained by the individual as:

(A) The amount described in §1.1244(c)–2(b) (3) (ii) bears to

(B) The total amount of money and other property received by the corporation in exchange for stock, as a contribution to capital, and as paid-in surplus in the transitional year.

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

Example 1. On December 1, 1978, Corporation W, a newly-formed corporation, issues 10,000 shares of common stock at $125 a share for an amount (determined under subparagraph (1) of this paragraph (b)) of money and other property totaling $1,250,000. The board of directors specifies that 8,000 shares are section 1244 stock and records the certificate numbers of the qualifying shares in its minutes. Because Corporation W issued post-November 1978 common stock in exchange for money and other property exceeding $1,000,000, but has designated shares of stock as section 1244 stock and the designated shares were issued in exchange for money and other property not exceeding $1,000,000 (8,000 shares × $125 price per share = $1,000,000), the 8,000 designated shares qualify as section 1244 stock.

Example 2. Corporation X comes into existence on June 1, 1979. On June 10, 1979, Corporation X issues 2,500 shares of common stock at $250 per share to shareholder A and 2,500 shares of common stock at $250 per share to shareholder B. By written agreement dated September 1, 1981, shareholder A and shareholder B determine that 1,500 of shareholder A's shares and all of shareholder B's shares will be treated as section 1244 stock. Although shareholder A's 1,500 shares and shareholder B's 2,500 shares were issued for money and other property not exceeding $1,000,000 (4,000 shares × $250 price per share = $1,000,000, these 4,000 shares do not qualify as section 1244 stock under the rules of subparagraph (2) of this paragraph (b) for three reasons: The agreement of September 1, 1979, (i) did not identify which 1,500 of shareholder A's 2,500 shares were intended to qualify for section 1244 treatment, (ii) was made by the shareholders and not by Corporation X, and (iii) was made later than the 15th day of the third month following the close of the transitional year. However, certain of the shares issued by Corporation X may qualify as section 1244 stock under the rules of subparagraph (3) of this paragraph (b). See example (4).

Example 3. On December 1, 1980, Corporation Y issues common stock to shareholder A in exchange for $500,000 in cash. On August 1, 1981, Corporation Y issues common stock to shareholder B in exchange for property having an adjusted basis to Corporation Y of $500,000. On December 1, 1981, B transfers a tract of land having a basis in B's hands of $250,000 to Corporation Y as a contribution to capital. Under section 362(a)(2) of the Code, Corporation Y takes a basis of $250,000 in the tract of land. Corporation Y is a calendar year corporation. On February 15, 1982, it designates all of shareholder B's stock as section 1244 stock by entering the numbers of the qualifying certificates on the corporation's records. The designation made by Corporation Y is effective because it identifies which shares of its stock qualify for section 1244 treatment, was made in writing before the 15th day of the 3rd month following the close of the transitional year (1981), and because the amount received for designated stock does not exceed $1,000,000, less amounts received (i) in exchange for stock in years prior to the transitional year; (ii) as contributions to capital in years prior to the transitional year; and (iii) as paid-in surplus in years prior to the transitional year. Nevertheless, in the event of B's sale of his stock at a loss, the increase in basis attributable to his December, 1981, contribution to capital will be treated as allocable to stock that is not section 1244 stock under §1.1244(d)–2.

Example 4. Corporation Z, a newly-formed corporation, issues 10,000 shares of common stock at $200 per share on July 1, 1979. In exchange for its stock Corporation Z receives property (other than stock or securities) having a basis to the corporation of $400,000, and $1,600,000 in cash, for a total of $2,000,000. Corporation Z fails to designate any of the issued shares as section 1244 stock. Shareholder C purchases 2,500 shares of the 10,000 shares of Corporation Z stock for $500,000 on

July 1, 1979. Subsequently, shareholder C sells the 2,500 shares for $400,000. Shareholder C may treat $50,000 of the $100,000 loss as an ordinary loss under section 1244. The amount of that loss is computed under the rule of subparagraph (3) of this paragraph (b) as follows:

$$\frac{X \text{ [C's section 1244 loss]}}{\$100{,}000 \text{ [C's total loss]}} = \frac{\$1{,}000{,}000 \text{ [\$1,000,000} - 0 = \$1{,}000{,}000\text{]}}{\$2{,}000{,}000 \text{ [total amount received by Corporation Z]}}$$

$$X = \$50{,}000$$

The remaining $50,000 is not treated as an ordinary loss under section 1244.

Example 5. (i) Corporation V, a newly-formed corporation, issues common stock to shareholder A and shareholder B on June 15, 1980, in exchange for $800,000 in cash ($400,000 from A and $400,000 from B). On September 15, 1981, the corporation issues common stock to shareholder C in exchange for $600,000 in cash. On January 1, 1982, common stock is issued to shareholder D in exchange for $100,000 in cash. Corporation V fails to designate any of the issued shares as section 1244 stock. A, B, C, and D subsequently sell their Corporation Y stock at a loss.

(ii) Subject to the annual limitation discussed in §1.1244(b)–1, A and B may treat their entire loss as an ordinary loss under section 1244. D may not treat any part of his loss as an ordinary loss under section 1244. Subject to the annual limitation, one-third of the loss sustained by shareholder C is treated as an ordinary loss under section 1244. These results are calculated under the rules of subparagraph (3) of this paragraph (b) as follows: First, section 1244 treatment is extended to post-November 1978 stock issued to A and B in 1980, a taxable year before the transitional year (1981); section 1244 treatment is withheld from the stock issued to D in 1982, a taxable year after the transitional year. Second $800,000 the amount of post-1958 capital received in taxable years before the transitional year, is subtracted from $1,000,000 to leave $200,000. Third, subject to the annual limitation, an ordinary loss is allowed to C in an amount which bears the same ratio to his total loss as the amount calculated in the preceding sentence ($200,000) bears to the total amount received by the corporation in the transitional year in exchange for stock, as a contribution to capital, or as paid-in surplus ($600,000).

Example 6. Corporation V comes into existence on July 1, 1982. On that date it issues 10 shares of voting common stock to shareholder A in exchange for $500,000 and 5 shares of voting common stock to shareholder B in exchange for $250,000, designating the shares issued to both A and B as section 1244 stock. On September 15, 1982, Corporation V receives a contribution to capital from shareholders A and B having a basis in their hands of $225,000. On February 1, 1983, Corporation V issues one share of stock to shareholder C in exchange for $50,000. Corporation V may designate one-half of the share issued to shareholder C as section 1244 stock under §1.1244(c)–2 (b)(2). In 1982 the corporation received $750,000 for stock ($500,000 from A and $250,000 from B) and $225,000 as a capital contribution, totaling $975,000 in capital receipts. The receipt of $50,000 from shareholder C in exchange for stock in 1983 causes capital receipts to exceed $1,000,000 and 1983 thus becomes Corporation V's transitional year. Corporation V may receive only $25,000 for designated stock in 1983 under the rule set forth in §1.1244 (c)–2 (b)(2)(i), which states that the amount received for designated stock shall not exceed $1,000,000, less amounts received (i) in exchange for stock in years prior to the transitional year ($750,000 from A and B), (ii) as contributions to capital in years prior to the transitional year ($225,000), and (iii) as paid-in surplus in years prior to the transitional year ($0). Thus, one-half of C's share (representing the receipt of $25,000) may be designated as section 1244 stock by Corporation V. In the event of the sale of A's stock or B's stock at a loss, the increase in basis attributable to their contribution to capital will be treated as allocable to stock that is not section 1244 stock under §1.1244(d)–2.

(c) *Pre-November 1978 stock*—(1) *Amount received by corporation for stock.* At the time of the adoption of the plan, the sum of the aggregate dollar amount to be paid for pre-November 1978 stock that may be offered under the plan plus the aggregate amount of money and other property that has been received by the corporation after June 30, 1958, and on or before November 6, 1978, for its stock, as a contribution to capital by its shareholders, and as paid-in surplus must not exceed $500,000. In making these determinations (i) property is taken into account at its adjusted basis to the corporation (for determining gain) as of the date received by the corporation, and (ii) this aggregate amount is reduced by the amount of any liability to which the property was subject and by the amount of any liability assumed by the corporation at the time the property was received. For purposes of the $500,000 test, the total amount of money and other property received for stock, as a contribution to capital, and as paid-in surplus is not reduced by distributions to shareholders, even though

the distributions may be capital distributions. Thus, once the total amount of money and other property received after June 30, 1958, reaches $500,000, the corporation is precluded from subsequently issuing pre-November 1978 stock. For a different rule that applies to post-November 1978 stock see § 1.1244(c)–2(b).

(2) *Equity capital*. The sum of the aggregate dollar amount to be paid for pre-November 1978 stock that may be offered under the plan plus the equity capital of the corporation (determined on the date of the adoption of the plan) may not exceed $1,000,000. For this purpose, equity capital is the sum of the corporation's money and other property (in an amount equal to its adjusted basis for determining gain) less the amount of the corporation's indebtedness to persons other than its shareholders.

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

Example 1. Corporation W comes into existence on December 1, 1958. On that date the corporation may adopt a plan to issue common stock for an amount (determined under subparagraph (1) of this paragraph (c)) not in excess of $500,000 during a period ending not later than November 30, 1960. Such corporation will qualify as a small business corporation as of the date that the plan is adopted. However, if the corporation adopts a plan to issue stock for an amount in excess of $500,000 it is not a small business corporation at the time the plan is adopted and no stock issued under the plan may qualify as section 1244 stock. If the cost of organizing corporation W amounted to $1,000 and constituted paid-in surplus or a contribution to capital, such amount must be taken into account in determining the amount that may be received under the plan, with the result that only $499,000 may be so received.

Example 2. On December 1, 1958, Corporation X, a newly formed corporation, adopts a plan to issue common stock for an amount (determined under subparagraph (1) of this paragraph (c)) not in excess of $500,000 during a period ending not later than November 30, 1960. By January 1, 1960, the corporation has, pursuant to the plan, issued at par, stock having an aggregate par value of $400,000, $200,000 of which was issued for $200,000 cash, and $200,000 of which was issued for property (other than stock or securities) having a basis to the corporation of $100,000 and a fair market value of $200,000. The corporation may, prior to November 30, 1960, issue stock for an amount not in excess of $200,000 cash or property having a basis to it not in excess of $200,000. Stock issued for any payment which, alone or together with any payments received after January 1, 1960, exceeds such $200,000 amount would not qualify as section 1244 stock because it would not be issued pursuant to the plan.

Example 3. Assume that on December 1, 1958, Corporation Y, a newly formed corporation, adopts a plan to issue common stock for an amount (determined under subparagraph (1) of this paragraph (c)) not in excess of $500,000 during a period ending not later than November 30, 1960. By January 1960 the corporation has received $400,000 cash for stock issued pursuant to the plan, but due to business successes the equity capital of the corporation exceeds $1,000,000. Since the equity capital test is made as of the date that the plan is adopted, the corporation may still, prior to November 30, 1960, issue section 1244 stock pursuant to the plan until the full amount specified in the plan has been received.

Example 4. Subsequent to June 30, 1958, Corporation Z receives a total of $600,000 cash on the issuance of its stock. In 1960 Corporation Z redeems shares of its stock for the total amount of $300,000 and the redemptions reduce Corporation Z's capital to substantially less than $500,000. Notwithstanding the redemptions, pre-November 1978 stock subsequently issued by Corporation Z will not qualify as section 1244 stock because the $500,000 limitation has been previously exceeded.

[T.D. 7779, 46 FR 29470, June 2, 1981, as amended by T.D. 7837, 47 FR 42729, Sept. 29, 1982; 60 FR 16575, Mar. 31, 1995]

§ 1.1244(d)–1 Contributions of property having basis in excess of value.

(a) *In general*. (1) Section 1244(d)(1)(A) provides a special rule which limits the amount of loss on section 1244 stock that may be treated as an ordinary loss. This rule applies only when section 1244 stock is issued by a corporation in exchange for property that, immediately before the exchange, has an adjusted basis (for determining loss) in excess of its fair market value. If section 1244 stock is issued in exchange for such property and the basis of such stock in the hands of the taxpayer is determined by reference to the basis of such property, then for purposes of section 1244, the basis of such stock shall be reduced by an amount equal to the excess, at the time of the exchange, of the adjusted basis of the property over its fair market value.

(2) The provisions of section 1244(d)(1)(A) do not affect the basis of stock for purposes other than section 1244. Such provisions are to be used only in determining the portion of the total loss sustained that may be treated as an ordinary loss pursuant to section 1244.

(b) *Transfer of more than one item.* If a taxpayer exchanges several items of property for stock in a single transaction so that the basis of the property transferred is allocated evenly among the shares of stock received, the computation under this section should be made by reference to the aggregate fair market value and the aggregate basis of the property transferred.

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

Example 1. B transfers property with an adjusted basis of $1,000 and a fair market value of $250 to a corporation for 10 shares of section 1244 stock in an exchange that qualifies under section 351. The basis of B's stock is $1,000 ($100 per share), but, solely for purposes of section 1244, the total basis of the stock must be reduced by $750, the excess of the adjusted basis of the property exchanged over its fair market value. Thus, the basis of such stock for purposes of section 1244 is $250 and the basis of each share for such purposes is $25. If B sells his 10 shares for $250, he will recognize a loss of $750, all of which must be treated as a capital loss. If he sells the 10 shares for $200, then $50 of his total loss of $800 will be treated as an ordinary loss under section 1244, assuming the various requirements of such section are satisfied, and the remaining $750 will be a capital loss.

Example 2. B owns property with a basis of $20,000. The fair market value of the property unencumbered is $15,000 but the property is subject to a $2,000 mortgage. B transfers the encumbered property to a corporation for 100 shares of section 1244 stock in an exchange that qualifies under section 351. The basis of the shares, determined in accordance with section 358, is $18,000 or $180 per share, but solely for purposes of section 1244 the basis is $13,000 ($130 per share), which is its basis for purposes other than section 1244, reduced by $5,000, the excess of the adjusted basis, immediately before the exchange, of the property transferred over its fair market value.

Example 3. C transfers business assets to a corporation for 100 shares of section 1244 stock in an exchange that qualifies under section 351. The assets transferred are as follows:

	Basis	Fair market value
Cash	$10,000	$10,000
Inventory	15,000	30,000
Depreciable property	50,000	20,000
Land	25,000	10,000
	100,000	70,000

The basis for the shares received by C is $100,000, which is applied $1,000 to each share. However, the basis of the shares for purposes of section 1244 is $70,000 ($700 per share), the basis for general purposes reduced by $30,000, the excess of the aggregate adjusted basis of the property transferred over the aggregate fair market value of such property.

[T.D. 6495, 25 FR 9679, Oct. 8, 1960]

§ 1.1244(d)–2 Increases in basis of section 1244 stock.

(a) *In general.* If subsequent to the time of its issuance there is for any reason, including the operation of section 1376(a), an increase in the basis of section 1244 stock, such increase shall be treated as allocable to stock which is not section 1244 stock. Therefore, a loss on stock, the basis of which has been increased subsequent to its issuance, must be apportioned between the part that qualifies as section 1244 stock and the part that does not so qualify. Only the loss apportioned to the part that so qualifies may be treated as an ordinary loss pursuant to section 1244. The amount of loss apportioned to the part that qualifies is the amount which bears the same ratio to the total loss as the basis of the stock which is treated as allocated to section 1244 stock bears to the total basis of the stock.

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

Example: For $10,000 a corporation issues 100 shares of section 1244 stock to X. X later contributes $2,000 to the capital of the corporation and this increases the total basis of his 100 shares to $12,000. Subsequently, he sells the 100 shares for $9,000. Of the $3,000 loss, $2,500 is allocated to the portion of the stock that qualifies as section 1244 stock ($10,000/$12,000 of $3,000), and the remaining $500 is allocated to the portion of the stock that does not so qualify. Therefore, to the extent of $2,500, the loss may be treated as an ordinary loss assuming the various requirements of section 1244 stock are satisfied.

However, the remaining $500 loss must be treated as a capital loss.

[T.D. 6495, 25 FR 9680, Oct. 8, 1960]

§ 1.1244(d)–3 Stock dividend, recapitalizations, changes in name, etc.

(a) *In general.* Section 1244(c)(1) provides that stock may not qualify for the benefits of section 1244 unless it is issued to the taxpayer for money or other property not including stock or securities. However, section 1244(d)(2) authorizes exceptions to this rule. The exceptions may apply in three situations: (1) The receipt of a stock dividend; (2) the exchange of stock for stock pursuant to a reorganization described in section 368(a)(1)(E); and (3) the exchange of stock for stock pursuant to a reorganization described in section 368(a)(1)(F).

(b) *Stock dividends.* (1) If common stock is received by an individual or partnership in a nontaxable distribution under section 305(a) made solely with respect to stock owned by such individual or partnership which meets the requirements of section 1244 stock determinable at the time of the distribution, then the common stock so received will also be treated as meeting such requirements. For purposes of this paragraph and paragraphs (c) and (d) of this section, the requirements of section 1244 stock determinable at the time of the distribution or exchange are all of the requirements of section 1244(c)(1) other than the one described in subparagraph (C) thereof, relating to the gross receipts test.

(2) If, however, such stock dividend is received by such individual or partnership partly with respect to stock meeting the requirements of section 1244 stock determinable at the time of the distribution, and partly with respect to stock not meeting such requirements, then only part of the stock received as a stock dividend will be treated as meeting such requirements. Assuming all the shares with respect to which the dividend is received have equal rights to dividends, such part is the number of shares which bears the same ratio to the total number of shares received as the number of shares owned immediately before the stock dividend which meets such qualifications bears to the total number of shares with respect to which the stock dividend is received. In determining the basis of shares received in the stock dividend and of the shares held before the stock dividend, section 307 shall apply as if two separate nontaxable stock dividends were made, one with respect to the shares that meet the requirements and the other with respect to shares that do not meet the requirements.

(3) The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. Corporation X issues 100 shares of its common stock to B for $1,000. Subsequently, in a nontaxable stock dividend B receives 5 more shares of common stock of Corporation X. If the 100 shares meet all the requirements of section 1244 stock determinable at the time of the distribution of the stock dividend, the 5 additional shares shall also be treated as meeting such requirements.

Example 2. In 1959, Corporation Y issues 100 shares of its common stock to C for $1,000 and these shares meet the requirements of section 1244 stock determinable at the time of the issuance. In 1960, C purchases an additional 200 shares of such stock from another shareholder for $3,000; however, these shares do not meet the requirements of section 1244 stock because they were not originally issued to C by the corporation. In 1961, C receives 15 shares of Corporation Y common stock as a stock dividend. Of the shares received, 5 shares, the number received with respect to the 100 shares of stock which met the requirements of section 1244 at the time of the distribution, i.e., $100/300 \times 15$, shall also be treated as meeting such requirements. The remaining 10 shares do not meet such requirements as they are not received with respect to section 1244 stock. The basis of such 5 shares is determined by applying section 307 as if the 5 shares were received as a separate stock dividend made solely with respect to shares that meet the requirements of section 1244 stock at the time of the distribution. Thus, the basis of the 5 shares is $47.61 ($^{5}/_{105}$ of $1,000).

(c) *Recapitalizations.* (1) If, pursuant to a recapitalization described in section 368(a)(1)(E), common stock of a corporation is received by an individual or partnership in exchange for stock of such corporation meeting the requirements of section 1244 stock determinable at the time of the exchange, such common stock shall be treated as meeting such requirements.

(2) If common stock is received pursuant to such a recapitalization partly

in exchange for stock meeting the requirements of section 1244 stock determinable at the time of the exchange and partly in exchange for stock not meeting such requirements, then only part of such common stock will be treated as meeting such requirements. Such part is the number of shares which bears the same ratio to the total number of shares of common stock so received as the basis of the shares transferred which meet such requirements bears to the basis of all the shares transferred for such common stock. The basis allocable, pursuant to section 358, to the common stock which is treated as meeting such requirements is limited to the basis of stock that meets such requirements transferred in the exchange.

(3) The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 3. A owns 500 shares of voting common stock of Corporation X. Corporation X revises its capital structure to provide for two classes of common stock: Class A voting and Class B nonvoting. In a recapitalization described in subparagraph (E) of section 368(a)(1). A exchanges his 500 shares for 750 shares of Class B nonvoting stock. If the 500 shares meet all the requirements of section 1244 stock determinable at the time of the exchange, the 750 shares received in the exchange are treated as meeting such requirements.

Example 4. B owns 500 shares of common stock of Corporation X with a basis of $5,000, and 100 shares of preferred stock of that corporation with a basis of $2,500. Pursuant to a recapitalization described in section 368(a)(1)(E), B exchanges all of his shares for 900 shares of common stock of Corporation X. The 500 common shares meet the requirements of section 1244 stock determinable at the time of the exchange, but the 100 preferred shares do not meet such requirements since only common stock may qualify. Of the 900 common shares received, 600 shares ($5,000/$7,500 × 900 shares) are treated as meeting the requirements of section 1244 stock at the time of the exchange, because they are deemed to be received in exchange for the 500 common shares which met such requirements. The remaining 300 shares do not meet such requirements as they are not deemed to be received in exchange for section 1244 stock. The basis of the 600 shares is $5,000, the basis of the relinquished shares meeting the requirements of section 1244.

(d) *Change of name, etc.* (1) If, pursuant to a reorganization described in section 368(a)(1)(F), common stock of a successor corporation is received by an individual or partnership in exchange for stock of the predecessor corporation meeting the requirements of section 1244 stock determinable at the time of the exchange, such common stock shall be treated as meeting such requirements. If common stock is received pursuant to such a reorganization partly in exchange for stock meeting the requirements of section 1244 stock determinable at the time of the exchange and partly in exchange for stock not meeting such requirements, the principles of paragraph (c)(2) of this section apply in determinating the number of shares received which are treated as meeting the requirements of section 1244 stock and the basis of those shares.

(2) For purposes of paragraphs (1)(C) and (3)(A) of section 1244(c), a successor corporation in a reorganization described in section 368(a)(1)(F) shall be treated as the same corporation as its predecessor.

[T.D. 7779, 46 FR 29472, June 2, 1981]

§ 1.1244(d)–4 Net operating loss deduction.

(a) *General rule.* For purpose of section 172, relating to the net operating loss deduction, any amount of loss that is treated as an ordinary loss under section 1244 (taking into account the annual dollar limitation of that section) shall be treated as attributable to the trade or business of the taxpayer. Therefore, this loss is allowable in determining the taxpayer's net operating loss for a taxable year and is not subject to the application of section 172(d)(4), relating to nonbusiness deductions. A taxpayer may deduct the maximum of ordinary loss permitted under section 1244(b) even though all or a portion of the taxpayer's net operating loss carryback or carryover for the taxable year was, when incurred, a loss on section 1244 stock.

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

Example: A, a single individual, computes a net operating loss of $15,000 for 1980 in accordance with the rules of § 1.172–3, relating to net operating loss in case of a taxpayer other than a corporation. Included within

A's computation of this net operating loss is a deduction arising under section 1244 for a loss on small business stock. A had no taxable income in 1977, 1978, or 1979. Assume that A can carry over the entire $15,000 loss under the rules of section 172. In 1981 A has gross income of $75,000 and again sustains a loss on section 1244 stock. The amount of A's 1981 loss on section 1244 stock is $50,000. A may deduct the full $50,000 as an ordinary loss under section 1244 and the full $15,000 as a net operating loss carryover in 1981.

[T.D. 7779, 46 FR 29473, June 2, 1981]

§ 1.1244(e)–1 Records to be kept.

(a) *By the corporation*—(1) *Mandatory records.* A plan to issue pre-November 1978 stock must appear upon the records of the corporation. Any designation of post-November 1978 stock under § 1.1244(c)–2(b)(2) also must appear upon the records of the corporation.

(2) *Discretionary records.* In order to substantiate an ordinary loss deduction claimed by its shareholders, the corporation should maintain records showing the following:

(i) The persons to whom stock was issued, the date of issuance to these persons, and a description of the amount and type of consideration received from each;

(ii) If the consideration received is property, the basis in the hands of the shareholder and the fair market value of the property when received by the corporation;

(iii) The amount of money and the basis in the hands of the corporation of other property received for its stock, as a contribution to capital, and as paid-in surplus;

(iv) Financial statements of the corporation, such as its income tax returns, that identify the source of the gross receipt of the corporation for the period consisting of the five most recent taxable years of the corporation, or, if the corporation has not been in existence for 5 taxable years, for the period of the corporation's existence;

(v) Information relating to any tax-free stock dividend made with respect to section 1244 stock and any reorganization in which stock is transferred by the corporation in exchange for section 1244 stock; and

(vi) With respect to pre-November 1978 stock;

(A) Which certificates represent stock issued under the plan;

(B) The amount of money and the basis in the hands of the corporation of other property received after June 30, 1958, and before the adoption of the plan, for its stock, as a contribution to capital, and as paid-in surplus; and

(C) The equity capital of the corporation on the date of adoption of the plan.

(b) *By the taxpayer.* A person who claims an ordinary loss with respect to stock under section 1244 must have records sufficient to establish that the taxpayer is entitled to the loss and satisfies the requirements of section 1244. See also section 6001, requiring records to be maintained.

In addition, a person who owns section 1244 stock in a corporation shall maintain records sufficient to distinguish such stock from any other stock he may own in the corporation.

[T.D. 6495, 25 FR 9681, Oct. 8, 1960, as amended by T.D. 7779, 46 FR 29473, June 2, 1981; 46 FR 31881, June 18, 1981; T.D. 8594, 60 FR 20898, Apr. 28, 1995]

§ 1.1245–1 General rule for treatment of gain from dispositions of certain depreciable property.

(a) *General.* (1) In general, section 1245(a)(1) provides that, upon a disposition of an item of section 1245 property, the amount by which the lower of (i) the *recomputed basis* of the property, or (ii) the amount realized on a sale, exchange, or involuntary conversion (or the fair market value of the property on any other disposition), exceeds the adjusted basis of the property shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income). The amount of such gain shall be determined separately for each item of section 1245 property. In general, the term *recomputed basis* means the adjusted basis of property plus all adjustments reflected in such adjusted basis on account of depreciation allowed or allowable for all periods after December 31, 1961. See section 1245(a)(2) and § 1.1245–2. Generally, the ordinary income treatment applies even though in the absence of

section 1245 no gain would be recognized under the Code. For example, if a corporation distributes section 1245 property as a dividend, gain may be recognized as ordinary income to the corporation even though, in the absence of section 1245, section 311(a) would preclude any recognition of gain to the corporation. For the definition of *section 1245 property*, see section 1245(a)(3) and § 1.1245–3. For exceptions and limitations to the application of section 1245(a)(1), see section 1245(b) and § 1.1245–4.

(2) Section 1245(a)(1) applies to dispositions of section 1245 property in taxable years beginning after December 31, 1962, except that:

(i) In respect of section 1245 property which is an elevator or escalator, section 1245(a)(1) applies to dispositions after December 31, 1963, and

(ii) In respect of section 1245 property which is livestock (described in subparagraph (4) of § 1.1245–3(a)), section 1245(a)(1) applies to dispositions made in taxable years beginning after December 31, 1969, and

(iii) [Reserved].

(3) For purposes of this section and §§ 1.1245–2 through 1.1245–6, the term *disposition* includes a sale in a sale-and-leaseback transaction and a transfer upon the foreclosure of a security interest, but such term does not include a mere transfer of title to a creditor upon creation of a security interest or to a debtor upon termination of a security interest. Thus, for example, a disposition occurs upon a sale of property pursuant to a conditional sales contract even though the seller retains legal title to the property for purposes of security but a disposition does not occur when the seller ultimately gives up his security interest following payment by the purchaser.

(4) For purposes of applying section 1245, the facts and circumstances of each disposition shall be considered in determining what is the appropriate item of section 1245 property. A taxpayer may treat any number of units of section 1245 property in any particular depreciation account (as defined in § 1.167(a)–7) as one item of section 1245 property as long as it is reasonably clear, from the best estimates obtainable on the basis of all the facts and circumstances, that the amount of gain to which section 1245(a)(1) applies is not less than the total of the gain under section 1245(a)(1) which would be computed separately for each unit. Thus, for example, if 50 units of section 1245 property X, 25 units of section 1245 property Y, and other property are accounted for in one depreciation account, and if each such unit is sold at a gain in one transaction in which the total gain realized on the sale exceeds the sum of the adjustments reflected in the adjusted basis (as defined in paragraph (a)(2) of § 1.1245–2) of each such unit on account of depreciation allowed or allowable for periods after December 31, 1961, all 75 units may be treated as one item of section 1245 property. If, however, 5 such units of section 1245 property Y were sold at a loss, then only 70 of such units (50 of X plus the 20 of Y sold at a gain) may be treated as one item of section 1245 property.

(5) In case of a sale, exchange, or involuntary conversion of section 1245 and non-section 1245 property in one transaction, the total amount realized upon the disposition shall be allocated between the section 1245 property and the non-section 1245 property in proportion to their respective fair market values. In general, if a buyer and seller have adverse interests as to the allocation of the amount realized between the section 1245 property and the non-section 1245 property, any arm's length agreement between the buyer and the seller will establish the allocation. In the absence of such an agreement, the allocation shall be made by taking into account the appropriate facts and circumstances. Some of the facts and circumstances which shall be taken into account to the extent appropriate include, but are not limited to, a comparison between the section 1245 property and all the property disposed of in such transaction of (i) the original cost and reproduction cost of construction, erection, or production, (ii) the remaining economic useful life, (iii) state of obsolescence, and (iv) anticipated expenditures to maintain, renovate, or to modernize.

(b) *Sale, exchange, or involuntary conversion.* (1) In the case of a sale, exchange, or involuntary conversion of section 1245 property, the gain to which

section 1245(a)(1) applies is the amount by which (i) the lower of the amount realized upon the disposition of the property or the recomputed basis of the property, exceeds (ii) the adjusted basis of the property.

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

Example 1. On January 1, 1964, Brown purchases section 1245 property for use in his manufacturing business. The property has a basis for depreciation of $3,300. After taking depreciation deductions of $1,300 (the amount allowable), Brown realizes after selling expenses the amount of $2,900 upon sale of the property on January 1, 1969. Brown's gain is $900 ($2,900 amount realized minus $2,000 adjusted basis). Since the amount realized upon disposition of the property ($2,900) is lower than its recomputed basis ($3,300, i.e., $2,000 adjusted basis plus $1,300 in depreciation deductions), the entire gain is treated as ordinary income under section 1245(a)(1) and not as gain from the sale or exchange of property described in section 1231.

Example 2. Assume the same facts as in example (1) except that Brown exchanges the section 1245 property for land which has a fair market value of $3,700, thereby realizing a gain of $1,700 ($3,700 amount realized minus $2,000 adjusted basis). Since the recomputed basis of the property ($3,300) is lower than the amount realized upon its disposition ($3,700), the excess of recomputed basis over adjusted basis, or $1,300, is treated as ordinary income under section 1245(a)(1). The remaining $400 of the gain may be treated as gain from the sale or exchange of property described in section 1231.

(c) *Other dispositions.* (1) In the case of a disposition of section 1245 property other than by way of a sale, exchange, or involuntary conversion, the gain to which section 1245(a)(1) applies is the amount by which (i) the lower of the fair market value of the property on the date of disposition or the recomputed basis of the property, exceeds (ii) the adjusted basis of the property. If property is transferred by a corporation to a shareholder for an amount less than its fair market value in a sale or exchange, for purposes of applying section 1245 such transfer shall be treated as a disposition other than by way of a sale, exchange, or involuntary conversion.

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

Example 1. X Corporation distributes section 1245 property to its shareholders as a dividend. The property has an adjusted basis of $2,000 to the corporation, a recomputed basis of $3,300, and a fair market value of $3,100. Since the fair market value of the property ($3,100) is lower than its recomputed basis ($3,300), the excess of fair market value over adjusted basis, or $1,100, is treated under section 1245(a)(1) as ordinary income to the corporation even though, in the absence of section 1245, section 311(a) would preclude recognition of gain to the corporation.

Example 2. Assume the same facts as in example (1) except that X Corporation distributes the section 1245 property to its shareholders in complete liquidation of the corporation. Assume further that section 1245(b)(3) does not apply and that the fair market value of the property is $3,800 at the time of the distribution. Since the recomputed basis of the property ($3,300) is lower than its fair market value ($3,800), the excess of recomputed basis over adjusted basis, or $1,300, is treated under section 1245(a)(1) as ordinary income to the corporation even though, in the absence of section 1245, section 336 would preclude recognition of gain to the corporation.

(d) *Losses.* Section 1245(a)(1) does not apply to losses. Thus, section 1245(a)(1) does not apply if a loss is realized upon a sale, exchange, or involuntary conversion of property, all of which is considered section 1245 property, nor does the section apply to a disposition of such property other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of such property is not greater than its adjusted basis.

(e) *Treatment of partnership and partners.* (1) The manner of determining the amount of gain recognized under section 1245(a)(1) to a partnership may be illustrated by the following example:

Example: A partnership sells for $63 section 1245 property which has an adjusted basis to the partnership of $30 and a recomputed basis to the partnership of $60. The partnership recognizes under section 1245(a)(1) gain of $30, i.e., the lower of the amount realized ($63) or recomputed basis ($60), minus adjusted basis ($30). This result would not be changed if one or more partners had, in respect of the property, a special basis adjustment described in section 743(b) or had taken depreciation deductions in respect of such special basis adjustment.

(2)(i) Unless paragraph (e)(3) of this section applies, a partner's distributive share of gain recognized under section

1245(a)(1) by the partnership is equal to the lesser of the partner's share of total gain from the disposition of the property (gain limitation) or the partner's share of depreciation or amortization with respect to the property (as determined under paragraph (e)(2)(ii) of this section). Any gain recognized under section 1245(a)(1) by the partnership that is not allocated under the first sentence of this paragraph (e)(2)(i) (excess depreciation recapture) is allocated among the partners whose shares of total gain from the disposition of the property exceed their shares of depreciation or amortization with respect to the property. Excess depreciation recapture is allocated among those partners in proportion to their relative shares of the total gain (including gain recognized under section 1245(a)(1)) from the disposition of the property that is allocated to the partners who are not subject to the gain limitation. See *Example 2* of paragraph (e)(2)(iii) of this section.

(ii)(A) Subject to the adjustments described in paragraphs (e)(2)(ii)(B) and (e)(2)(ii)(C) of this section, a partner's share of depreciation or amortization with respect to property equals the total amount of allowed or allowable depreciation or amortization previously allocated to that partner with respect to the property.

(B) If a partner transfers a partnership interest, a share of depreciation or amortization must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the partner transfers a portion of the partnership interest, a share of depreciation or amortization proportionate to the interest transferred must be allocated to the transferee partner.

(C)(*1*) A partner's share of depreciation or amortization with respect to property contributed by the partner includes the amount of depreciation or amortization allowed or allowable to the partner for the period before the property is contributed.

(*2*) A partner's share of depreciation or amortization with respect to property contributed by a partner is adjusted to account for any curative allocations. (See §1.704–3(c) for a description of the traditional method with curative allocations.) The contributing partner's share of depreciation or amortization with respect to the contributed property is decreased (but not below zero) by the amount of any curative allocation of ordinary income to the contributing partner with respect to that property and by the amount of any curative allocation of deduction or loss (other than capital loss) to the noncontributing partners with respect to that property. A noncontributing partner's share of depreciation or amortization with respect to the contributed property is increased by the noncontributing partner's share of any curative allocation of ordinary income to the contributing partner with respect to that property and by the amount of any curative allocation of deduction or loss (other than capital loss) to the noncontributing partner with respect to that property. The partners' shares of depreciation or amortization with respect to property from which curative allocations of depreciation or amortization are taken is determined without regard to those curative allocations. See *Example 3(iii)* of paragraph (e)(2)(iii) of this section.

(*3*) A partner's share of depreciation or amortization with respect to property contributed by a partner is adjusted to account for any remedial allocations. (See §1.704–3(d) for a description of the remedial allocation method.) The contributing partner's share of depreciation or amortization with respect to the contributed property is decreased (but not below zero) by the amount of any remedial allocation of income to the contributing partner with respect to that property. A noncontributing partner's share of depreciation or amortization with respect to the contributed property is increased by the amount of any remedial allocation of depreciation or amortization to the noncontributing partner with respect to that property. See *Example 3(iv)* of paragraph (e)(2)(iii) of this section.

(*4*) If, under paragraphs (e)(2)(ii)(C)(*2*) and (e)(2)(ii)(C)(*3*) of this section, the partners' shares of depreciation or amortization with respect to a contributed property exceed the adjustments reflected in the adjusted basis of the

property under § 1.1245–2(a) at the partnership level, then the partnership's gain recognized under section 1245(a)(1) with respect to that property is allocated among the partners in proportion to their relative shares of depreciation or amortization (subject to any gain limitation that might apply).

(*5*) This paragraph (e)(2)(ii)(C) also applies in determining a partner's share of depreciation or amortization with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to § 1.704–1(b)(2)(iv)(*f*).

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

Example 1. Recapture allocations. (i) *Facts.* A and B each contribute $5,000 cash to form AB, a general partnership. The partnership agreement provides that depreciation deductions will be allocated 90 percent to A and 10 percent to B, and, on the sale of depreciable property, A will first be allocated gain to the extent necessary to equalize A's and B's capital accounts. Any remaining gain will be allocated 50 percent to A and 50 percent to B. In its first year of operations, AB purchases depreciable equipment for $5,000. AB depreciates the equipment over its 5-year recovery period and elects to use the straight-line method. In its first year of operations, AB's operating income equals its expenses (other than depreciation). (To simplify this example, AB's depreciation deductions are determined without regard to any first-year depreciation conventions.)

(ii) *Year 1.* In its first year of operations, AB has $1,000 of depreciation from the partnership equipment. In accordance with the partnership agreement, AB allocates 90 percent ($900) of the depreciation to A and 10 percent ($100) of the depreciation to B. At the end of the year, AB sells the equipment for $5,200, recognizing $1,200 of gain ($5,200 amount realized less $4,000 adjusted tax basis). In accordance with the partnership agreement, the first $800 of gain is allocated to A to equalize the partners' capital accounts, and the remaining $400 of gain is allocated $200 to A and $200 to B.

(iii) *Recapture allocations.* $1,000 of the gain from the sale of the equipment is treated as section 1245(a)(1) gain. Under paragraph (e)(2)(i) of this section, each partner's share of the section 1245(a)(1) gain is equal to the lesser of the partner's share of total gain recognized on the sale of the equipment or the partner's share of total depreciation with respect to the equipment. Thus, A's share of the section 1245(a)(1) gain is $900 (the lesser of A's share of the total gain ($1,000) and A's share of depreciation ($900)). B's share of the section 1245(a)(1) gain is $100 (the lesser of B's share of the total gain ($200) and B's share of depreciation ($100)). Accordingly, $900 of the $1,000 of total gain allocated to A is treated as ordinary income and $100 of the $200 of total gain allocated to B is treated as ordinary income.

Example 2. Recapture allocation subject to gain limitation. (i) *Facts.* A, B, and C form general partnership ABC. The partnership agreement provides that depreciation deductions will be allocated equally among the partners, but that gain from the sale of depreciable property will be allocated 75 percent to A and 25 percent to B. ABC purchases depreciable personal property for $300 and subsequently allocates $100 of depreciation deductions each to A, B, and C, reducing the adjusted tax basis of the property to $0. ABC then sells the property for $440. ABC allocates $330 of the gain to A (75 percent of $440) and allocates $110 of the gain to B (25 percent of $440). No gain is allocated to C.

(ii) *Application of gain limitation.* Each partner's share of depreciation with respect to the property is $100. C's share of the total gain from the disposition of the property, however, is $0. As a result, under the gain limitation provision in paragraph (e)(2)(i) of this section, C's share of section 1245(a)(1) gain is limited to $0.

(iii) *Excess depreciation recapture.* Under paragraph (e)(2)(i) of this section, the $100 of section 1245(a)(1) gain that cannot be allocated to C under the gain limitation provision (excess depreciation recapture) is allocated to A and B (the partners not subject to the gain limitation at the time of the allocation) in proportion to their relative shares of total gain from the disposition of the property. A's relative share of the total gain allocated to A and B is 75 percent ($330 of $440 total gain). B's relative share of the total gain allocated to A and B is 25 percent ($110 of $440 total gain). However, under the gain limitation provision of paragraph (e)(2)(i) of this section, B cannot be allocated 25 percent of the excess depreciation recapture ($25) because that would result in a total allocation of $125 of depreciation recapture to B (a $100 allocation equal to B's share of depreciation plus a $25 allocation of excess depreciation recapture), which is in excess of B's share of the total gain from the disposition of the property ($110). Therefore, only $10 of excess depreciation recapture is allocated to B and the remaining $90 of excess depreciation recapture is allocated to A. A is not subject to the gain limitation because A's share of the total gain ($330) still exceeds A's share of section 1245(a)(1) gain ($190). Accordingly, all $110 of the total gain allocated to B is treated as ordinary income ($100 share of depreciation allocated to B plus $10 of excess depreciation recapture) and $190 of the total

gain allocated to A is treated as ordinary income ($100 share of depreciation allocated to A plus $90 of excess depreciation recapture).

Example 3. Determination of partners' shares of depreciation with respect to contributed property. (i) *Facts.*C and D form partnership CD as equal partners. C contributes depreciable personal property C1 with an adjusted tax basis of $800 and a fair market value of $2,800. Prior to the contribution, C claimed $200 of depreciation from C1. At the time of the contribution, C1 is depreciable under the straight-line method and has four years remaining on its 5-year recovery period. D contributes $2,800 cash, which CD uses to purchase depreciable personal property D1, which is depreciable over seven years under the straight-line method. (To simplify the example, all depreciation is determined without regard to any first-year depreciation conventions.)

(ii) *Traditional method.* C1 generates $700 of book depreciation (¼ of $2,800 book value) and $200 of tax depreciation (¼ of $800 adjusted tax basis) each year. C and D will each be allocated $350 of book depreciation from C1 in year 1. Under the traditional method of making section 704(c) allocations, D will be allocated the entire $200 of tax depreciation from C1 in year 1. D1 generates $400 of book and tax depreciation each year (1/7 of $2,800 book value and adjusted tax basis). C and D will each be allocated $200 of book and tax depreciation from D1 in year 1. As a result, after the first year of partnership operations, C's share of depreciation with respect to C1 is $200 (the depreciation taken by C prior to contribution) and D's share of depreciation with respect to C1 is $200 (the amount of tax depreciation allocated to D). C and D each have a $200 share of depreciation with respect to D1. At the end of four years, C's share of depreciation with respect to C1 will be $200 (the depreciation taken by C prior to contribution) and D's share of depreciation with respect to C1 will be $800 (four years of $200 depreciation per year). At the end of four years, C and D will each have an $800 share of depreciation with respect to D1 (four years of $200 depreciation per year).

(iii) *Effect of curative allocations.* (A) *Year 1.* If the partnership elects to make curative allocations under § 1.704–3(c) using depreciation from D1, the results will be the same as under the traditional method, except that $150 of the $200 of tax depreciation from D1 that would be allocated to C under the traditional method will be allocated to D as additional depreciation with respect to C1. As a result, after the first year of partnership operations, C's share of depreciation with respect to C1 will be reduced to $50 (the total depreciation taken by C prior to contribution ($200) decreased by the amount of the curative allocation to D ($150)). D's share of depreciation with respect to C1 will be $350 (the depreciation allocated to D under the traditional method ($200) increased by the amount of the curative allocation to D ($150)). C and D will each have a $200 share of depreciation with respect to D1.

(B) *Year 4.* At the end of four years, C's share of depreciation with respect to C1 will be reduced to $0 (the total depreciation taken by C prior to contribution ($200) decreased, but not below zero, by the amount of the curative allocations to D ($600)), and D's share of depreciation with respect to C1 will be $1,400 (the total depreciation allocated to D under the traditional method ($800) increased by the amount of the curative allocations to D ($600)). However, CD's section 1245(a)(1) gain with respect to C1 will not be more than $1,000 (CD's tax depreciation ($800) plus C's tax depreciation prior to contribution ($200)). Under paragraph (e)(2)(ii)(C)(*4*) of this section, because the partners' shares of depreciation with respect to C1 exceed the adjustments reflected in the property's adjusted basis, CD's section 1245(a)(1) gain will be allocated in proportion to the partners' relative shares of depreciation with respect to C1. Because C's share of depreciation with respect to C1 is $0, and D's share of depreciation with respect to C1 is $1,400, all of CD's $1,000 of section 1245(a)(1) gain will be allocated to D. At the end of four years, C and D will each have an $800 share of depreciation with respect to D1 (four years of $200 depreciation per year).

(iv) *Effect of remedial allocations.* (A) *Year 1.* If the partnership elects to make remedial allocations under § 1.704–3(d), there will be $600 of book depreciation from C1 in year 1. (Under the remedial allocation method, the amount by which C1's book basis ($2,800) exceeds its tax basis ($800) is depreciated over a 5-year life, rather than a 4-year life.) C and D will each be allocated one-half ($300) of the total book depreciation. As under the traditional method, D will be allocated all $200 of tax depreciation from C1. Because the ceiling rule would cause a disparity of $100 between D's book and tax allocations of depreciation, D will also receive a $100 remedial allocation of depreciation with respect to C1, and C will receive a $100 remedial allocation of income with respect to C1. As a result, after the first year of partnership operations, D's share of depreciation with respect to C1 is $300 (the depreciation allocated to D under the traditional method ($200) increased by the amount of the remedial allocation ($100)). C's share of depreciation with respect to C1 is $100 (the total depreciation taken by C prior to contribution ($200) decreased by the amount of the remedial allocation of income ($100)). C and D will each have a $200 share of depreciation with respect to D1.

(B) *Year 5.* At the end of five years, C's share of depreciation with respect to C1 will be $0 (the total depreciation taken by C prior to contribution ($200) decreased, but not

below zero, by the total amount of the remedial allocations of income to C ($600)). D's share of depreciation with respect to C1 will be $1,400 (the total depreciation allocated to D under the traditional method ($800) increased by the total amount of the remedial allocations of depreciation to D ($600)). However, CD's section 1245(a)(1) gain with respect to C1 will not be more than $1,000 (CD's tax depreciation ($800) plus C's tax depreciation prior to contribution ($200)). Under paragraph (e)(2)(ii)(C)(*4*) of this section, because the partners' shares of depreciation with respect to C1 exceed the adjustments reflected in the property's adjusted basis, CD's section 1245(a)(1) gain will be allocated in proportion to the partners' relative shares of depreciation with respect to C1. Because C's share of depreciation with respect to C1 is $0, and D's share of depreciation with respect to C1 is $1,400, all of CD's $1,000 of section 1245(a)(1) gain will be allocated to D. At the end of five years, C and D will each have a $1,000 share of depreciation with respect to D1 (five years of $200 depreciation per year).

(iv) *Effective date.* This paragraph (e)(2) is effective for properties acquired by a partnership on or after August 20, 1997. However, partnerships may rely on this paragraph (e)(2) for properties acquired before August 20, 1997 and disposed of on or after August 20, 1997.

(3)(i) If (*a*) a partner had a special basis adjustment under section 743(b) in respect of section 1245 property, or (*b*) on the date he acquired his partnership interest by way of a sale or exchange (or upon death of another partner) the partnership owned section 1245 property and an election under section 754 (relating to optional adjustment to basis of partnership property) was in effect with respect to the partnership, then the amount of gain recognized under section 1245(a)(1) by him upon a disposition by the partnership of such property shall be determined under this subparagraph.

(ii) There shall be allocated to such partner, in the same proportion as the partnership's total gain is allocated to him as his distributive share under section 704, a portion of (*a*) the common partnership adjusted basis for the property, and (*b*) the amount realized by the partnership upon the disposition, or, if nothing is realized, the fair market value of the property. There shall also be allocated to him, in the same proportion as the partnership's gain recognized under section 1245(a)(1) is allocated under subparagraph (2) of this paragraph as his distributive share of such gain, a portion of *the adjustments reflected in the adjusted basis* (as defined in paragraph (a)(2) of § 1.1245–2) of such property. If on the date he acquired his partnership interest by way of a sale or exchange the partnership owned such property and an election under section 754 was in effect, then for purposes of the preceding sentence the amount of the adjustments reflected in the adjusted basis of such property on such date shall be deemed to be zero. For special rules relating to the amount of adjustments reflected in the adjusted basis of property after partnership transactions, see paragraph (c)(6) of § 1.1245–2.

(iii) The partner's adjusted basis in respect of the property shall be deemed to be (*a*) the portion of the partnership's adjusted basis for the property allocated to the partner under subdivision (ii) of this subparagraph, (*b*) increased by the amount of any special basis adjustment described in section 743(b)(1) (or decreased by the amount of any special basis adjustment described in section 743(b)(2) which the partner may have in respect of the property on the date the partnership disposed of the property.

(iv) The partner's recomputed basis in respect of the property shall be deemed to be (*a*) the sum of the partner's adjusted basis for the property, as determined in subdivision (iii) of this subparagraph, plus the amount of *the adjustments reflected in the adjusted basis* (as defined in paragraph (a)(2) of § 1.1245–2) for the property allocated to the partner under subdivision (ii) of this subparagraph, (*b*) increased by the amount by which any special basis adjustment described in section 743(b)(1) (or decreased by the amount by which any special basis adjustment described in section 743(b)(2)) in respect of the property was reduced, but only to the extent such amount was applied to adjust the amount of the deductions allowed or allowable to the partner for depreciation or amortization of section 1245 property attributable to periods referred to in paragraph (a)(2) of § 1.1245–2. The terms *allowed or allowable*, *depreciation or amortization*, and *attributable to periods* shall have the

meanings assigned to these terms in paragraph (a) of § 1.1245–2.

(4) The application of subparagraph (3) of this paragraph may be illustrated by the following example:

Example: A, B, and C each hold a one-third interest in calendar year partnership ABC. On December 31, 1962, the firm holds section 1245 property which has an adjusted basis of $30,000 and a recomputed basis of $33,000. Depreciation deductions in respect of the property for 1962 were $3,000. On January 1, 1963, when D purchases C's partnership interest, the election under section 754 is in effect and a $5,000 special basis adjustment is made in respect of D to his one-third share of the common partnership adjusted basis for the property. For 1963 and 1964 the partnership deducts $6,000 as depreciation in respect of the property, thereby reducing its adjusted basis to $24,000, and D deducts $2,800, i.e., his distributive share of partnership depreciation ($2,000) plus depreciation in respect of his special basis adjustment ($800). On March 15, 1965, the partnership sells the property for $48,000. Since the partnership's recomputed basis for the property ($33,000, i.e., $24,000 adjusted basis plus $9,000 in depreciation deductions) is lower than the amount realized upon the sale ($48,000), the excess of recomputed basis over adjusted basis, or $9,000, is treated as partnership gain under section 1245(a)(1). D's distributive share of such gain is $3,000 (⅓ of $9,000). However, the amount of gain recognized by D under section 1245 (a)(1) is only $2,800, determined as follows:

(1) Adjusted basis:		
D's portion of partnership adjusted basis (⅓ of $24,000)	$8,000	
D's special basis adjustment as of December 31, 1964 ($5,000 minus $800)	4,200	
D's adjusted basis		$12,200
(2) Recomputed basis:		
D's adjusted basis	12,200	
D's portion of partnership depreciation for 1963 and 1964, i.e., for periods after he acquired his partnership interest (⅓ of $6,000)	2,000	
Depreciation for 1963 and 1964 in respect of D's special basis adjustment	800	
D's recomputed basis.		15,000
(3) D's portion of amount realized by partnership (⅓ of $48,000)		16,000
(4) Gain recognized to D under section 1245(a)(1), i.e., the lower of (2) or (3), minus (1)		2,800

[T.D. 6832, 30 FR 8576, July 7, 1965, as amended by T.D. 7084, 36 FR 268, Jan. 8, 1971; T.D. 7141, 36 FR 18793, Sept. 22, 1971; T.D. 8730, 62 FR 44216, Aug. 20, 1997]

§ 1.1245–2 Definition of recomputed basis.

(a) *General rule*—(1) *Recomputed basis defined*. The term *recomputed basis* means, with respect to any property, an amount equal to the sum of:

(i) The adjusted basis of the property, as defined in section 1011, plus

(ii) The amount of the adjustments reflected in the adjusted basis.

(2) *Definition of adjustments reflected in adjusted basis*. The term *adjustments reflected in the adjusted basis* means:

(i) With respect to any property other than property described in subdivision (ii), (iii), or (iv) of this subparagraph, the amount of the adjustments attributable to periods after December 31, 1961,

(ii) With respect to an elevator or escalator, the amount of the adjustments attributable to periods after June 30, 1963,

(iii) With respect to livestock (described in subparagraph (4) of § 1.1245–3(a)), the amount of the adjustments attributable to periods after December 31, 1969, or

(iv) [Reserved]

which are reflected in the adjusted basis of such property on account of deductions allowed or allowable for depreciation or amortization (within the meaning of subparagraph (3) of this paragraph). For cases where the taxpayer can establish that the amount allowed for any period was less than the amount allowable, see subparagraph (7) of this paragraph. For determination of adjusted basis of property in a multiple asset account, see paragraph (c)(3) of § 1.167(a)–8.

(3) *Meaning of depreciation or amortization*. (i) For purposes of subparagraph (2) of this paragraph, the term *depreciation or amortization* includes allowances (and amounts treated as allowances) for depreciation (or amortization in lieu thereof), and deductions for amortization of emergency facilities under section 168. Thus, for example, such term includes a reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence) under section 167, an expense allowance (additional first-year depreciation allowance for property placed in service before January 1, 1981), under section 179, an expenditure treated as

an amount allowed under section 167 by reason of the application of section 182(d)(2)(B) (relating to expenditures by farmers for clearing land), and a deduction for depreciation of improvements under section 611 (relating to depletion). For further examples, the term *depreciation or amortization* includes periodic deductions referred to in § 1.162–11 in respect of a specified sum paid for the acquisition of a leasehold and in respect of the cost to a lessee of improvements on property of which he is the lessee. However, such term does not include deductions for the periodic payment of rent.

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

Example: On January 1, 1966, Smith purchases for $1,000, and places in service, an item of property described in section 1245(a)(3)(A). Smith deducts an additional first-year allowance for depreciation under section 179 of $200. Accordingly, the basis of the property for purposes of depreciation is $800 on January 1, 1966. Between that date and January 1, 1974, Smith deducts $640 in depreciation (the amount allowable) with respect to the property, thereby reducing its adjusted basis to $160. Since this adjusted basis reflects deductions for depreciation and amortization (within the meaning of this subparagraph) amounting to $840 ($200 plus $640), the recomputed basis of the property is $1,000 ($160 plus $840).

(4) *Adjustments of other taxpayers or in respect of other property.* (i) For purposes of subparagraph (2) of this paragraph, the adjustments reflected in adjusted basis on account of depreciation or amortization which must be taken into account in determining recomputed basis are not limited to those adjustments on account of depreciation or amortization with respect to the property disposed of, nor are such adjustments limited to those on account of depreciation or amortization allowed or allowable to the taxpayer disposing of such property. Except as provided in subparagraph (7) of this paragraph, all such adjustments are taken into account, whether the deductions were allowed or allowable in respect of the same or other property and whether to the taxpayer or to any other person. For manner of determining the amount of adjustments reflected in the adjusted basis of property immediately after certain dispositions, see paragraph (c) of this section.

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

Example: On January 1, 1966, Jones purchases machine X for use in his trade or business. The machine, which is section 1245 property, has a basis for depreciation of $10,000. After taking depreciation deductions of $2,000 (the amount allowable), Jones transfers the machine to his son as a gift on January 1, 1968. Since the exception for gifts in section 1245(b)(1) applies, Jones does not recognize gain under section 1245(a)(1). The son's adjusted basis for the machine is $8,000. On January 1, 1969, after taking a depreciation deduction of $1,000 (the amount allowable), the son exchanges machine X for machine Y in a like kind exchange described in section 1031. Since the exception for like kind exchanges in section 1245(b)(4) applies, the son does not recognize gain under section 1245(a)(1). The son's adjusted basis for machine Y is $7,000. In 1969, the son takes a depreciation deduction of $1,000 (the amount allowable) in respect of machine Y. The son sells machine Y on June 30, 1970. No depreciation was allowed or allowable for 1970, the year of the sale. The recomputed basis of machine Y on June 30, 1970, is determined in the following manner:

Adjusted basis	$6,000	
Adjustments reflected in the adjusted basis:		
Depreciation deducted by Jones for 1966 and 1967 on machine X	2,000	
Depreciation deducted by son for 1968 on machine X	1,000	
Depreciation deducted by son for 1969 on machine Y	1,000	
Total adjustments reflected in the adjusted basis		$4,000
Recomputed basis		10,000

(5) *Adjustments reflected in adjusted basis of property described in section 1245(a)(3)(B).* For purposes of subparagraph (2) of this paragraph, the adjustments reflected in the adjusted basis of property described in section 1245(a)(3)(B), on account of depreciation or amortization which must be taken into account in determining recomputed basis, may include deductions attributable to periods during which the property is not used as an integral part of an activity, or does not constitute a facility, specified in section 1245(a)(3)(B) (i) or (ii). Thus, for example, if depreciation deductions taken with respect to such property after December 31, 1961, amount to

$10,000 (the amount allowable), of which $6,000 is attributable to periods during which the property is used as an integral part of a specified activity or constitutes a specified facility, then the entire $10,000 of depreciation deductions are adjustments reflected in the adjusted basis for purposes of determining recomputed basis. Moreover, if the property was never so used but was acquired in a transaction to which section 1245(b)(4) (relating to like kind exchanges and involuntary conversions) applies, and if by reason of the application of paragraph (d)(3) of § 1.1245–4 the property is considered as section 1245 property described in section 1245(a)(3)(B), then the entire $10,000 of depreciation deductions would also be adjustments reflected in the adjusted basis for purposes of determining recomputed basis.

(6) *Allocation of adjustments attributable to periods after certain dates.* (i) For purposes of determining recomputed basis, the amount of adjustments reflected in the adjusted basis of property other than property described in subparagraph (2) (ii), (iii), or (iv) of this paragraph are limited to adjustments attributable to periods after December 31, 1961. Accordingly, if depreciation deducted with respect to such property of a calendar year taxpayer is $1,000 a year (the amount allowable) for each of 10 years beginning with 1956, only the depreciation deducted in 1962 and succeeding years shall be treated as reflected in the adjusted basis for purposes of determining recomputed basis. With respect to a taxable year beginning in 1961 and ending in 1962, the deduction for depreciation or amortization shall be ascertained by applying the principles stated in paragraph (c)(3) of § 1.167(a)–8 (relating to determination of adjusted basis of retired asset). The amount of the deduction, determined in such manner, shall be allocated on a daily basis in order to determine the portion thereof which is attributable to a period after December 31, 1961. Thus, for example, if a taxpayer, whose fiscal year ends on May 31, 1962, acquires section 1245 property on November 12, 1961, and the deduction for depreciation attributable to the property for such fiscal year is ascertained (under the principles of paragraph (c)(3) of § 1.167(a)–8) to be $400, then the portion thereof attributable to a period after December 31, 1961, is $302 ($^{151}/_{200}$ of $400). If, however, the property were acquired by such taxpayer after December 31, 1961, the entire deduction for depreciation attributable to the property for such fiscal year would be allocable to a period after December 31, 1961. For treatment of certain normal retirements described in paragraph (e)(2) of § 1.167(a)–8, see paragraph (c) of § 1.1245–6. For principles of determining the amount of adjustments for depreciation or amortization reflected in the adjusted basis of property upon an abnormal retirement of property in a multiple asset account, see paragraph (c)(3) of § 1.167(a)–8.

(ii) For purposes of determining recomputed basis, the amount of adjustments reflected in the adjusted basis of an elevator or escalator are limited to adjustments attributable to periods after June 30, 1963.

(iii) For purposes of determining recomputed basis, the amount of adjustments reflected in the adjusted basis of livestock (described in subparagraph (2)(iii) of this paragraph) are limited to adjustments attributable to periods after December 31, 1969.

(7) *Depreciation or amortization allowed or allowable.* For purposes of determining recomputed basis, generally all adjustments (for periods after Dec. 31, 1961, or, in the case of property described in subparagraph (2) (ii), (iii), or (iv) of this paragraph, for periods after the applicable date) attributable to allowed or allowable depreciation or amortization must be taken into account. See section 1016(a)(2) and the regulations thereunder for the meaning of *allowed* and *allowable*. However, if a taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for depreciation or amortization for any period was less than the amount allowable for such period, the amount to be taken into account for such period shall be the amount allowed. No adjustment is to be made on account of the tax imposed by section 56 (relating to the minimum tax for tax preferences). See paragraph (b) of this section (relating to records to be kept and information

to be filed). For example, assume that in the year 1967 it becomes necessary to determine the recomputed basis of property, the $500 adjusted basis of which reflects adjustments of $1,000 with respect to depreciation deductions allowable for periods after December 31, 1961. If the taxpayer can establish by adequate records or other sufficient evidence that he had been allowed deductions amounting to only $800 for the period, then in determining recomputed basis the amount added to adjusted basis with respect to the $1,000 adjustments to basis for the period will be only $800.

(8) *Exempt organizations.* In respect of property disposed of by an organization which is or was exempt from income taxes (within the meaning of section 501(a)), adjustments reflected in the adjusted basis (within the meaning of subparagraph (2) of this paragraph) shall include only depreciation or amortization allowed or allowable (i) in computing unrelated business taxable income (as defined in section 512(a), or (ii) in computing taxable income of the organization (or a predecessor organization) for a period during which it was not exempt or, by reason of the application of section 502, 503, or 504, was denied its exemption.

(b) *Records to be kept.* In any case in which it is necessary to determine recomputed basis of an item of section 1245 property, the taxpayer shall have available permanent records of all the facts necessary to determine with reasonable accuracy the amount of such recomputed basis, including the following:

(1) The date, and the manner in which, the property was acquired,

(2) The taxpayer's basis on the date the property was acquired and the manner in which the basis was determined,

(3) The amount and date of all adjustments to the basis of the property allowed or allowable to the taxpayer for depreciation or amortization and the amount and date of any other adjustments by the taxpayer to the basis of the property,

(4) In the case of section 1245 property which has an adjusted basis reflecting adjustments for depreciation or amortization taken by the taxpayer with respect to other property, or by another taxpayer with respect to the same or other property, the information described in subparagraphs (1), (2), and (3) of this paragraph with respect to such other property or such other taxpayer.

(c) *Adjustments reflected in adjusted basis immediately after certain acquisitions*—(1) *Zero.* (i) If on the date a person acquires property his basis for the property is determined solely by reference to its cost (within the meaning of section 1012), then on such date the amount of the adjustments reflected in his adjusted basis for the property is zero.

(ii) If on the date a person acquires property his basis for the property is determined solely by reason of the application of section 301(d) (relating to basis of property received in corporate distribution) or section 334(a) (relating to basis of property received in a liquidation in which gain or loss is recognized), then on such date the amount of the adjustments reflected in his adjusted basis for the property is zero.

(iii) If on the date a person acquires property his basis for the property is determined solely under the rules of section 334 (b)(2) or (c) relating to basis of property received in certain corporate liquidations), then on such date the amount of the adjustments reflected in his adjusted basis for the property is zero.

(iv) If as of the date a person acquires property from a decedent such person's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), then on such date the amount of the adjustments reflected in his adjusted basis for the property is zero.

(2) *Gifts and certain tax-free transactions.* (i) If property is disposed of in a transaction described in subdivision (ii) of this subparagraph, then the amount of the adjustments reflected in the adjusted basis of the property in the hands of a transferee immediately after the disposition shall be an amount equal to:

(*a*) The amount of the adjustments reflected in the adjusted basis of the property in the hands of the transferor immediately before the disposition, minus

(*b*) The amount of any gain taken into account under section 1245(a)(1) by the transferor upon the disposition.

(ii) The transactions referred to in paragraph (c)(2)(i) of this section are:

(A) A disposition that is in part a sale or exchange and in part a gift (see § 1.1245–4(a)(3));

(B) A disposition (other than a disposition to which section 1245(b)(6)(A) applies) that is described in section 1245(b)(3) (relating to certain tax-free transactions);

(C) An exchange described in § 1.1245–4(e)(2) (relating to transfers described in section 1081(d)(1)(A)); or

(D) A transfer at death where the basis of property in the hands of the transferee is determined under section 1022.

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

Example: Jones transfers section 1245 property to a corporation in exchange for stock of the corporation and $1,000 cash in a transaction which qualifies under section 351 (relating to transfer to a corporation controlled by transferor). Before the exchange the amount of the adjustments reflected in the adjusted basis of the property is $3,000. Upon the exchange $1,000 gain is recognized under section 1245(a)(1). Immediately after the exchange, the amount of the adjustments reflected in the adjusted basis of the property in the hands of the corporation is $2,000 (that is, $3,000 minus $1,000).

(3) *Certain transfers at death.* (i) If property is acquired in a transfer at death to which section 1245(b)(2) applies, the amount of the adjustments reflected in the adjusted basis of property in the hands of the transferee immediately after the transfer shall be the amount (if any) of depreciation or amortization deductions allowed the transferee before the decedent's death, to the extent that the basis of the property (determined under section 1014(a)) is required to be reduced under the second sentence of section 1014(b)(9) (relating to adjustments to basis where property is acquired from a decedent prior to his death).

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

Example: H purchases section 1245 property in 1965 which he immediately conveys to himself and W, his wife, as tenants by the entirety. Under local law each spouse is entitled to one-half the income from the property. H and W file joint income tax returns for calendar years 1965, 1966, and 1967. Over the 3 years, depreciation deductions amounting to $4,000 (the amount allowable) are allowed in respect of the property of which one-half thereof, or $2,000, is allocable to W. On January 1, 1968, H dies and the entire value of the property at the date of death is included in H's gross estate. Since W's basis for the property (determined under section 1014(a)) is reduced (under the second sentence of section 1014(b)(9)) by the $2,000 depreciation deductions allowed W before H's death, the adjustments reflected in the adjusted basis of the property in the hands of W immediately after H's death amount to $2,000.

(4) *Property received in a like kind exchange, involuntary conversion, or F.C.C. transaction.* (i) If property is acquired in a transaction described in subdivision (ii) of this subparagraph then immediately after the acquisition (and before applying subparagraph (5) of this paragraph, if applicable) the amount of the adjustments reflected in the adjusted basis of the property acquired shall be an amount equal to:

(*a*) The amount of the adjustments reflected in the adjusted basis of the property disposed of immediately before the disposition, minus

(*b*) The sum of (*1*) the amount of any gain recognized under section 1245(a)(1) upon the disposition, plus (*2*) the amount of gain (if any) referred to in subparagraph (5)(ii) of this paragraph.

(ii) The transactions referred to in subdivision (i) of this subparagraph are:

(*a*) A disposition which is a like kind exchange or an involuntary conversion to which section 1245(b)(4) applies, or

(*b*) A disposition to which the provisions of section 1071 and paragraph (e)(1) of § 1.1245–4 apply.

(iii) The provisions of subdivisions (i) and (ii) of this subparagraph may be illustrated by the following examples:

Example 1. Smith exchanges machine A for machine B and $1,000 cash in a like kind exchange. Gain of $1,000 is recognized under section 1245(a)(1). If before the exchange the amount of the adjustments reflected in the

adjusted basis of machine A was $5,000, the amount of adjustments reflected in the adjusted basis of machine B after the exchange is $4,000 (that is, $5,000 minus $1,000).

Example 2. Assume the same facts as in example (1) except that machine A is destroyed by fire, that $5,000 in insurance proceeds are received of which $4,000 is used to purchase machine B, and that Smith properly elects under section 1033(a)(3)(A) to limit recognition of gain. The result is the same as in example (1), that is, the amount of adjustments reflected in the adjusted basis of machine B is $4,000 ($5,000 minus $1,000).

(iv) If more than one item of section 1245 property is acquired in a transaction referred to in subdivision (i) of this subparagraph, the total amount of the adjustments reflected in the adjusted bases of the items acquired shall be allocated to such items in proportion to their respective adjusted bases.

(5) *Property after a reduction in basis pursuant to election under section 1071 or application of section 1082(a)(2).* If the basis of section 1245 property is reduced pursuant to an election under section 1071 (relating to gain from sale or exchange to effectuate policies of F.C.C.), or the application of section 1082(a)(2) (relating to sale or exchange in obedience to order of S.E.C.), then immediately after the basis reduction the amount of the adjustments reflected in the adjusted basis of the property shall be the sum of:

(i) The amount of the adjustments reflected in the adjusted basis of the property immediately before the basis reduction (but after applying subparagraph (4) of this paragraph, if applicable), plus

(ii) The amount of gain which was not recognized under section 1245(a)(1) by reason of the reduction in the basis of the property. See paragraph (e)(1) of § 1.1245–4.

(6) *Partnership property after certain transactions.* (i) For the amount of adjustments reflected in the adjusted basis of property immediately after certain distributions of the property by a partnership to a partner, see section 1245(b)(6)(B).

(ii) If under paragraph (b)(3) of § 1.751–1 (relating to certain distributions of partnership property other than section 751 property treated as sales or exchanges) a partnership is treated as purchasing section 1245 property (or a portion thereof) from a distributee who relinquishes his interest in such property (or portion), then on the date of such purchase the amount of adjustments reflected in the adjusted basis of such purchased property (or portion) shall be zero.

(iii) See paragraph (e)(3)(ii) of § 1.1245–1 for the amount of adjustments reflected in the adjusted basis of partnership property in respect of a partner who acquired his partnership interest in certain transactions when an election under section 754 (relating to optional adjustments to basis of partnership property) was in effect.

(d) *Effective/applicability date.* This section applies on and after January 19, 2017. For rules before January 19, 2017, see § 1.1245–2 as contained in 26 CFR part 1 revised as of April 1, 2016.

[T.D. 6832, 30 FR 8578, July 7, 1965, as amended by T.D. 7084, 36 FR 268, Jan. 8, 1971; T.D. 7141, 36 FR 18793, Sept. 22, 1971; 36 FR 19160, Sept. 30, 1971; T.D. 7564, 43 FR 40496, Sept. 12, 1978; T.D. 8121, 52 FR 414, Jan. 6, 1987; T.D. 9811, 82 FR 6241, Jan. 19, 2017]

§ 1.1245–3 Definition of section 1245 property.

(a) *In general.* (1) The term *section 1245 property* means any property (other than livestock excluded by the effective date limitation in subparagraph (4) of this paragraph) which is or has been property of a character subject to the allowance for depreciation provided in section 167 and which is either:

(i) Personal property (within the meaning of paragraph (b) of this section),

(ii) Property described in section 1245(a)(3)(B) (see paragraph (c) of this section), or

(iii) An elevator or an escalator within the meaning of subparagraph (C) of section 48(a)(1) (relating to the definition of *section 38 property* for purposes of the investment credit), but without regard to the limitations in such subparagraph (C).

(2) If property is section 1245 property under a subdivision of subparagraph (1) of this paragraph, a leasehold of such property is also section 1245 property under such subdivision. Thus, for example, if A owns personal property which is section 1245 property under subparagraph (1)(i) of this paragraph,

and if A leases the personal property to B, B's leasehold is also section 1245 property under such provision. For a further example, if C owns and leases to D for a single lump-sum payment of $100,000 property consisting of land and a fully equipped factory building thereon, and if 40 percent of the fair market value of such property is properly allocable to section 1245 property, then 40 percent of D's leasehold is also section 1245 property. A leasehold of land is not section 1245 property.

(3) Even though property may not be of a character subject to the allowance for depreciation in the hands of the taxpayer, such property may nevertheless be section 1245 property if the taxpayer's basis for the property is determined by reference to its basis in the hands of a prior owner of the property and such property was of a character subject to the allowance for depreciation in the hands of such prior owner, or if the taxpayer's basis for the property is determined by reference to the basis of other property that in the hands of the taxpayer was property of a character subject to the allowance for depreciation, or if the taxpayer's basis for the property is determined under section 1022 and such property was of a character subject to the allowance for depreciation in the hands of the decedent. Thus, for example, if a father uses an automobile in his trade or business during a period after December 31, 1961, and then gives the automobile to his son as a gift for the son's personal use, the automobile is section 1245 property in the hands of the son.

(4) Section 1245 property includes livestock, but only with respect to taxable years beginning after December 31, 1969. For purposes of section 1245, the term *livestock* includes horses, cattle, hogs, sheep, goats, and mink and other furbearing animals, irrespective of the use to which they are put or the purpose for which they are held.

(b) *Personal property defined*. The term *personal property* means:

(1) Tangible personal property (as defined in paragraph (c) of §1.48–1, relating to the definition of *section 38 property* for purposes of the investment credit), and

(2) Intangible personal property.

(c) *Property described in section 1245(a)(3)(B)*. (1) The term *property described in section 1245(a)(3)(B)* means tangible property of the requisite depreciable character other than personal property (and other than a building and its structural components), but only if there are adjustments reflected in the adjusted basis of the property (within the meaning of paragraph (a)(2) of §1.1245–2) for a period during which such property (or other property):

(i) Was 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

(ii) Constituted a research or storage facility used in connection with any of the foregoing activities.

Thus, even though during the period immediately preceding its disposition the property is not used as an integral part of an activity specified in subdivision (i) of this subparagraph and does not constitute a facility specified in subdivision (ii) of this subparagraph, such property is nevertheless property described in section 1245(a)(3)(B) if, for example, there are adjustments reflected in the adjusted basis of the property for a period during which the property was used as an integral part of manufacturing by the taxpayer or another taxpayer, or for a period during which other property (which was involuntarily converted into, or exchanged in a like kind exchange for, the property) was so used by the taxpayer or another taxpayer. For rules applicable to involuntary conversions and like kind exchanges, see paragraph (d)(3) of §1.1245–4.

(2) The language used in subparagraph (1) (i) and (ii) of this paragraph shall have the same meaning as when used in paragraph (a) of §1.48–1, and the terms *building* and *structural components* shall have the meanings assigned to those terms in paragraph (e) of §1.48–1.

(d) *Effective/applicability date*. This section applies on and after January 19, 2017. For rules before January 19, 2017,

see § 1.1245–3 as contained in 26 CFR part 1 revised as of April 1, 2016.

[T.D. 6832, 30 FR 8580, July 7, 1965, as amended by T.D. 7141, 36 FR 18794, Sept. 22, 1971; T.D. 9811, 82 FR 6241, Jan. 19, 2017]

§ 1.1245–4 Exceptions and limitations.

(a) *Exception for gifts*—(1) *General rule*. Section 1245(b)(1) provides that no gain shall be recognized under section 1245(a)(1) upon a disposition by gift. For purposes of this paragraph (a), the term *gift* means, except to the extent that paragraph (a)(3) of this section applies, a transfer of property that, in the hands of the transferee, has a basis determined under the provisions of section 1015(a) or 1015(d) (relating to basis of property acquired by gifts) or section 1022 (relating to basis of property acquired from certain decedents who died in 2010). For reduction in amount of charitable contribution in case of a gift of section 1245 property, see section 170(e) and the regulations thereunder.

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

Example 1. A places section 1245 property in trust to pay the income from the property to B for his life, and after B's death to distribute the property to C. If the basis of the property to the fiduciary and to C is determined under the uniform basis rules prescribed in paragraph (b) of § 1.1015–1, and under paragraph (c) of § 1.1015–1 the time the fiduciary and C acquire their interests in the property is the time the donor relinquished dominion over the property, then section 1245(a)(1) does not apply to the transfer by A to the trust or to the distribution to C.

Example 2. Assume the same facts as in example (1), except that the fiduciary sells the section 1245 property and reinvests the proceeds in other section 1245 property which is distributed to C upon B's death. Assume further that under paragraph (f) of § 1.1015–1 C's basis for the distributed property is the cost or other basis to the fiduciary. Section 1245(a)(1) applies to the sale but not to the distribution.

(3) *Disposition in part a sale or exchange and in part a gift*. Where a disposition of property is in part a sale or exchange and in part a gift, the gain to which section 1245(a)(1) applies is the amount by which (i) the lower of the amount realized upon the disposition of the property or the recomputed basis of the property, exceeds (ii) the adjusted basis of the property. For determination of the recomputed basis of the property in the hands of the transferee, see paragraph (c)(2) of § 1.1245–2.

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

Example: (i) Smith transfers section 1245 property, which he has held in excess of 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), to his son for $60,000. Immediately before the transfer the property in the hands of Smith has an adjusted basis of $30,000, a fair market value of $90,000, and a recomputed basis of $110,000. Since the amount realized upon disposition of the property ($60,000) is lower than its recomputed basis ($110,000), the excess of the amount realized over adjusted basis, or $30,000, is treated as ordinary income under section 1245(a)(1) and not as gain from the sale or exchange of property described in section 1231. Smith has made a gift of $30,000 ($90,000 fair market value minus $60,000 amount realized) to which section 1245(a)(1) does not apply.

(ii) Immediately before the transfer, the amount of adjustments reflected in the adjusted basis of the property was $80,000. Under paragraph (c)(2) of § 1.1245–2, $50,000 of adjustments are reflected in the adjusted basis of the property immediately after the transfer, that is, $80,000 of such adjustments immediately before the transfer, minus $30,000 gain taken into account under section 1245(a)(1) upon the transfer. Thus, the recomputed basis of the property in the hands of the son is $110,000.

(b) *Exception for transfers at death*—(1) *General rule*. Section 1245(b)(2) provides that, except as provided in section 691 (relating to income in respect of a decedent), no gain shall be recognized under section 1245(a)(1) upon a transfer at death. For purposes of this paragraph, the term *transfer at death* means a transfer of property which, in the hands of the transferee, has a basis determined under the provisions of section 1014(a) (relating to basis of property acquired from a decedent) because of the death of the transferor. For recomputed basis of property acquired in a transfer at death, see paragraph (c)(1)(iv) of § 1.1245–2.

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

Example 1. Smith owns section 1245 property which, upon Smith's death, is inherited by his son. Since the property is described in section 1014(b)(1), its basis in the hands of the son is determined under the provisions of section 1014(a). Therefore, section 1245(a)(1) does not apply to the transfer at Smith's death.

Example 2. H purchases section 1245 property which he conveys to himself and W, his wife, as tenants by the entirety. Upon H's death in 1970 the property (including W's share) is included in his gross estate. Since the entire property is described in section 1014(b) (1) and (9), its basis in the hands of W is determined under the provisions of section 1014(a). Therefore, section 1245(a)(1) does not apply to the transfer at H's death. For determination of the recomputed basis of the property in the hands of W, see paragraph (c)(3) of § 1.1245–2.

Example 3. Green's will provides for the bequest of section 1245 property to trustees to pay the income from the property to his wife for her lifetime, and upon her death to distribute the property to his son. If under paragraph (a)(2) of § 1.1014–4 the son's unadjusted basis for the property is its fair market value at the time the decedent died, section 1245(a)(1) does not apply to the distribution of the property to the son.

Example 4. The trustee of a trust created by will transfers section 1245 property to a beneficiary in satisfaction of a specific bequest of $10,000. If under the principles of paragraph (a)(3) of § 1.1014–4 the trust realizes a taxable gain upon the transfer, section 1245(a)(1) applies to the transfer.

(c) *Limitation for certain tax-free transactions*—(1) *Limitation on amount of gain.* Section 1245(b)(3) provides that upon a transfer of property described in subparagraph (2) of this paragraph, the amount of gain taken into account by the transferor under section 1245(a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer (determined without regard to section 1245). For purposes of this subparagraph, in case of a transfer of both section 1245 property and non-section 1245 property in one transaction, the amount realized from the disposition of the section 1245 property (as determined under paragraph (a)(5) of § 1.1245–1) shall be deemed to consist of that portion of the fair market value of each property acquired which bears the same ratio to the fair market value of such acquired property as the amount realized from the disposition of the section 1245 property bears to the total amount realized. The preceding sentence shall be applied solely for purposes of computing the portion of the total gain (determined without regard to section 1245) which shall be recognized as ordinary income under section 1245(a)(1). For determination of the recomputed basis of the section 1245 property in the hands of the transferee, see paragraph (c)(2) of § 1.1245–2. Section 1245(b)(3) does not apply to a disposition of property to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code.

(2) *Transfers covered.* The transfers referred to in subparagraph (1) of this paragraph are transfers of property in which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(i) Section 332 (relating to distributions in complete liquidation of an 80-percent-or-more controlled subsidiary corporation). See subparagraph (3) of this paragraph.

(ii) Section 351 (relating to transfer to a corporation controlled by transferor).

(iii) Section 361 (relating to exchanges pursuant to certain corporate reorganizations).

(iv) Section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings).

(v) Section 374(a) (relating to exchanges pursuant to certain railroad reorganizations).

(vi) Section 721 (relating to transfers to a partnership in exchange for a partnership interest).

(vii) Section 731 (relating to distributions by a partnership to a partner). For special carryover basis rule, see section 1245(b)(6)(A) and paragraph (f)(1) of this section.

(3) *Complete liquidation of subsidiary.* In the case of a distribution in complete liquidation of an 80-percent-or-more controlled subsidiary to which section 332 applies, the limitation provided in section 1245(b)(3) is confined to instances in which the basis of the property in the hands of the transferee is determined, under section 334(b)(1), by reference to its basis in the hands of the transferor. Thus, for example, the limitation of section 1245(b)(3) may

apply in respect of a liquidating distribution of section 1245 property by an 80-percent-or-more controlled corporation to the parent corporation, but does not apply in respect of a liquidating distribution of section 1245 property to a minority shareholder. Section 1245(b)(3) does not apply to a liquidating distribution of property by an 80-percent-or-more controlled subsidiary to its parent if the parent's basis for the property is determined, under section 334(b)(2), by reference to its basis for the stock of the subsidiary.

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

Example 1. Section 1245 property, which is owned by Smith, has a fair market value of $10,000, a recomputed basis of $8,000, and an adjusted basis of $4,000. Smith transfers the property to a corporation in exchange for stock in the corporation worth $9,000 plus $1,000 in cash in a transaction qualifying under section 351. Without regard to section 1245, Smith would recognize $1,000 gain under section 351(b), and the corporation's basis for the property would be determined under section 362(a) by reference to its basis in the hands of Smith. Since the recomputed basis of the property disposed of ($8,000) is lower than the amount realized ($10,000), the excess of recomputed basis over adjusted basis ($4,000), or $4,000, would be treated as ordinary income under section 1245(a)(1) if the provisions of section 1245(b)(3) did not apply. However, section 1245(b)(3) limits the gain taken into account by Smith under section 1245(a)(1) to $1,000. If, instead, Smith transferred the property to the corporation solely in exchange for stock of the corporation worth $10,000, then, because of the application of section 1245(b)(3), Smith would not take any gain into account under section 1245(a)(1). If, however, Smith transferred the property to the corporation for stock worth $5,000 and $5,000 cash, only $4,000 of the $5,000 gain under section 351(b) would be treated as ordinary income under section 1245(a)(1).

Example 2. Assume the same facts as in example (1) except that Smith contributes the property to a new partnership in which he has a one-half interest. Since, without regard to section 1245, no gain would be recognized to Smith under section 721, and by reason of the application of section 721 the partnership's basis for the property would be determined under section 723 by reference to its basis in the hands of Smith, the application of section 1245(b)(3) results in no gain being taken into account by Smith under section 1245(a)(1).

Example 3. Assume the same facts as in example (2) except that the property is subject to a $9,000 mortgage. Since under section 752(b) (relating to decrease in partner's liabilities) Smith is treated as receiving a distribution in money of $4,500 (one-half of liability assumed by partnership), and since the basis of Smith's partnership interest is $4,000 (the adjusted basis of the contributed property), the $4,500 distribution results in his realizing $500 gain under section 731(a) (relating to distributions by a partnership), determined without regard to section 1245. Accordingly, the application of section 1245(b)(3) limits the gain taken into account by Smith under section 1245(a)(1) to $500.

(d) *Limitation for like kind exchanges and involuntary conversions*—(1) *General rule*. Section 1245(b)(4) provides that if property is disposed of and gain (determined without regard to section 1245) is not recognized in whole or in part under section 1031 (relating to like kind exchanges) or section 1033 (relating to involuntary conversions), then the amount of gain taken into account by the transferor under section 1245(a)(1) shall not exceed the sum of:

(i) The amount of gain recognized on such disposition (determined without regard to section 1245), plus

(ii) The fair market value of property acquired which is not section 1245 property and which is not taken into account under subdivision (i) of this subparagraph (that is, the fair market value of non-section 1245 property acquired which is qualifying property under section 1031 or 1033, as the case may be).

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

Example 1. Smith exchanges machine A for machine B in a like kind exchange as to which no gain is recognized under section 1031(a). Both machines are section 1245 property. No gain is recognized under section 1245(a)(1) because of the limitation contained in section 1245(b)(4). The result would be the same if machine A were involuntarily converted into machine B in a transaction as to which no gain is recognized under section 1033(a)(1).

Example 2. Jones owns property A, which is section 1245 property, with an adjusted basis of $100,000 and a recomputed basis of $116,000. The property is destroyed by fire and Jones receives $117,000 of insurance proceeds. Thus, the amount of gain under section 1245(a)(1), determined without regard to section 1245(b)(4), would be $16,000. He uses $105,000 of

the proceeds to purchase section 1245 property similar or related in service or use to property A, and $9,000 of the proceeds to purchase stock in the acquisition of control of a corporation owning property similar or related in service or use to property A. Both acquisitions qualify under section 1033(a)(3)(A). Jones properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain to the amount by which the amount realized from the conversion exceeds the cost of the stock and other property acquired to replace the converted property. Since $3,000 of the gain is recognized (without regard to section 1245) under section 1033(a)(3) (that is, $117,000 minus $114,000), and since the stock purchased for $9,000 is not section 1245 property and was not taken into account in determining the gain under section 1033, section 1245(b)(4) limits the amount of the gain taken into account under section 1245(a)(1) to $12,000 (that is, $3,000 plus $9,000). If, instead of purchasing $9,000 in stock, Jones purchases $9,000 worth of property which is section 1245 property similar or related in use to the destroyed property, section 1245(b)(4) would limit the amount of gain taken into account under section 1245(a)(1) to $3,000.

(3) *Certain tangible property*. If:

(i) A person disposes of section 1245 property in a transaction to which section 1245(b)(4) applies,

(ii) Adjustments are reflected in the adjusted basis (within the meaning of paragraph (a)(2) of §1.1245–2) of such property which are attributable to the use of such property (or other property) as an integral part of an activity, or as a facility, specified in section 1245(a)(3)(B) (i) or (ii), and

(iii) Property is acquired in the transaction which would be considered as section 1245 property described in section 1245(a)(3)(B) if such person used the acquired property as an integral part of such an activity, or as such a facility, then (regardless of the use of the acquired property) the acquired property shall be considered as section 1245 property described in section 1245(a)(3)(B). For definition of property described in section 1245(a)(3)(B), see paragraph (c) of §1.1245–3. Thus, for example, if a person's section 1245 property (which is personal property) is involuntarily converted into property A which would qualify as section 1245 property only if it were devoted to a specified use, and if the person had so devoted the section 1245 property disposed of, then the acquired property is considered as section 1245 property described in section 1245(a)(3)(B) and therefore its fair market value is not taken into account under subparagraph (1)(ii) of this paragraph. For recomputed basis of property A, see paragraph (a)(5) of §1.1245–2. Moreover, if property A is not devoted to a specified use and is subsequently involuntarily converted into property B which would qualify as section 1245 property only if it were so devoted, then property B is also considered as section 1245 property described in section 1245(a)(3)(B).

(4) *Application to disposition of section 1245 property and nonsection 1245 property in one transaction*. For purposes of this paragraph, if both section 1245 property and nonsection 1245 property are acquired as the result of one disposition in which both section 1245 property and nonsection 1245 property are disposed of, then except as provided in subparagraph (7) of this paragraph:

(i) The total amount realized upon the disposition shall be allocated (in a manner consistent with the principles of paragraph (a)(5) of §1.1245–1) between the section 1245 property and the nonsection 1245 property disposed of in proportion to their respective fair market values.

(ii) The amount realized upon the disposition of the section 1245 property shall be deemed to consist of so much of the fair market value of the section 1245 property acquired as is not in excess of the amount realized from the section 1245 property disposed of, and the remaining portion (if any) of the amount realized upon the disposition of the section 1245 property shall be deemed to consist of so much of the fair market value of the non-section 1245 property acquired as is not in excess of the amount of such remaining portion, and

(iii) The amount realized upon the disposition of the non-section 1245 property shall be deemed to consist of so much of the fair market value of all the property acquired which was not taken into account in subdivision (ii) of this subparagraph.

(5) *Example*. The provisions of subparagraph (4) of this paragraph may be illustrated by the following example:

Example: (i) Smith owns section 1245 property A with a fair market value of $30,000, and non-section 1245 property X with a fair market value of $20,000. Properties A and X are destroyed by fire and Smith receives insurance proceeds of $40,000. He uses all the proceeds, plus additional cash of $10,000, to purchase in a single transaction properties B and Y which qualify under section 1033(a)(3)(A), and he properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain to the excess of the amount realized from the conversion over the costs of the qualifying properties acquired. Thus no gain would be recognized (without regard to section 1245) under section 1033(a)(3)(A). Property B is section 1245 property with a fair market value of $15,000, and property Y is non-section 1245 property with a fair market value of $35,000.

(ii) The amount realized upon the disposition of A and X ($40,000) is allocated between A and X in proportion to their respective fair market values. Thus, the amount considered realized in respect of A is $24,000 (that is, 30/50 of $40,000). (The amount considered realized in respect of X is $16,000 (that is, 20/50 of $40,000).)

(iii) The $24,000 realized upon the disposition of A is deemed to consist of the fair market value of B ($15,000) and $9,000 of the fair market value of Y. (The $16,000 realized upon the disposition of X is deemed to consist of $16,000 of the fair market value of Y. Also, $10,000 of the fair market value of Y is attributable to the additional cash of $10,000.)

(iv) Assume that A has an adjusted basis of $5,000, and a recomputed basis of $40,000. Since the amount considered realized upon the disposition of A ($24,000) is lower than its recomputed basis ($40,000), the amount of gain which would be recognized under section 1245(a)(1), determined without regard to section 1245(b)(4), is $19,000, that is, the amount realized ($24,000) minus the adjusted basis ($5,000). Since no gain is recognized (without regard to section 1245) under section 1033(a)(3), and since $9,000 of the property acquired in exchange for section 1245 property A is non-section 1245 property Y, section 1245(b)(4) limits the amount of gain taken into account under section 1245(a)(1) to $9,000.

(6) *Cross references.* For the manner of determining the recomputed basis of property acquired in a transaction to which section 1245(b)(4) applies, see paragraph (c)(4) of § 1.1245–2. For the manner of determining the basis of such property, see paragraph (a) of § 1.1245–5.

(7) *Coordination with section 1250.* For purposes of this paragraph, if section 1245 property and section 1250 property are disposed of in one transaction in which the property acquired includes section 1250 property, the allocation rules of paragraph (d)(6) of § 1.1250–3 shall apply.

(e) *Limitation for section 1071 and 1081 transactions*—(1) *Section 1071 and 1081(b) transactions.* If property is disposed of and gain (determined without regard to section 1245) is not recognized in whole or in part because of the application of section 1071 (relating to gain from sale or exchange to effectuate policies of F.C.C.) or section 1081(b) (relating to gain from sale or exchange in obedience to order of S.E.C.), then the amount of gain taken into account by the transferor under section 1245(a)(1) shall not exceed the sum of:

(i) The amount of gain recognized on such disposition (determined without regard to section 1245),

(ii) In the case of a transaction to which section 1071 applies, the fair market value of property acquired which is not section 1245 property and which is not taken into account under subdivision (i) of this subparagraph, plus

(iii) The amount by which the basis of property, other than section 1245 property, is reduced (pursuant to an election under section 1071 or pursuant to the application of section 1082(a)(2)), and which is not taken into account under subdivision (i) or (ii) of this subparagraph.

(2) *Section 1081(d)(1)(A) transaction.* No gain shall be recognized under section 1245(a)(1) upon an exchange of property as to which gain would not be recognized (without regard to section 1245) because of the application of section 1081(d)(1)(A) (relating to transfers within system group). For recomputed basis of property acquired in a transaction referred to in this subparagraph, see paragraph (c)(2) of § 1.1245–2.

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

Example 1. Corporation X elects under section 1071 to treat a sale of section 1245 property for $100,000 as an involuntary conversion subject to the provisions of section 1033, but does not elect to reduce the basis of depreciable property pursuant to an election under section 1071. The corporation uses $35,000 of the proceeds to purchase section 1245 property and $40,000 to purchase other

property. Both properties qualify as replacement property under section 1033. Assuming that the amount of gain under section 1245(a)(1) (determined without regard to this paragraph) would be $70,000, and that $25,000 of gain would be recognized (without regard to section 1245) upon the application of section 1071, the amount of gain taken into account under section 1245(a)(1) is $65,000 ($25,000 plus $40,000).

Example 2. (i) Assume the same facts as in example (1) except that the corporation elects under section 1071 to reduce its basis for property of a character subject to the allowance for depreciation under section 167 by the amount of gain which would be recognized without regard to the application of section 1245, that is, by $25,000. Assume further that under section 1071 the corporation may reduce the basis of depreciable property consisting of property A, which is section 1245 property with an adjusted basis of $30,000, and property B, which is property other than section 1245 property with an adjusted basis of $20,000. Under paragraph (a)(2) of § 1.1071–3, the $25,000 of unrecognized gain is applied to reduce the basis of property A by $15,000 (30,000/50,000 of $25,000) and the basis of property B by $10,000 (20,000/50,000 of $25,000).

(ii) The amount of gain which would be recognized (determined without regard to section 1245) under section 1071 is zero, i.e., the amount determined in example (1) ($25,000), minus the amount of the reduction in basis of depreciable property pursuant to the election ($25,000). The amount of gain taken into account under section 1245(a)(1) is $50,000, i.e., the sum of (*a*) the gain which would be recognized without regard to section 1245 (zero), (*b*) the cost of property acquired which is not section 1245 property ($40,000), plus (c) the amount by which the basis of property B is reduced ($10,000). For method of increasing basis of property B, see paragraph (b)(2) of § 1.1245–5, and for recomputed basis of property A, see paragraph (c)(5) of § 1.1245–2.

(f) *Limitation for property distributed by a partnership*—(1) *In general.* For purposes of section 1245(b)(3) (relating to certain tax-free transactions), the basis of section 1245 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.

(2) *Adjustments reflected in the adjusted basis.* If section 1245 property is distributed by a partnership to a partner, then, for purposes of determining the recomputed basis of the property in the hands of the distributee, the amount of the adjustments reflected in the adjusted basis of the property immediately after the distribution shall be an amount equal to:

(i) The potential section 1245 income (as defined in paragraph (c)(4) of § 1.751–1) of the partnership in respect of the property immediately before the distribution, reduced by

(ii) The portion of such potential section 1245 income which is recognized as ordinary income to the partnership under paragraph (b)(2)(ii) of § 1.751–1.

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

Example 1. (i) A machine, which is section 1245 property owned by partnership ABC, has an adjusted basis of $9,000, a recomputed basis of $18,000, and a fair market value of $15,000. Since the fair market value of the machine is lower than its recomputed basis, the potential section 1245 income in respect of the machine is the excess of fair market value over adjusted basis, or $6,000. The partnership distributes the machine to C in a complete liquidation of his partnership interest to which section 736(a) does not apply. C, who had originally contributed the machine to the partnership, has a basis for his partnership interest of $10,000. Since section 751(b)(2)(A) provides that section 751(b)(1) does not apply to a distribution of property to the partner who contributed the property, no gain would be recognized to the partnership under section 731(b) (without regard to the application of section 1245). By reason of the application of section 731, C's basis for the property would, under section 732(b), be equal to his basis for his interest in the partnership, or $10,000.

(ii) Since section 731 applies to the distribution, and since subparagraph (1) of this paragraph provides that, for purposes of section 1245(b)(3), C's basis for the property is deemed to be determined by reference to the adjusted basis of the property to the partnership, the gain taken into account under section 1245(a)(1) by the partnership is limited by section 1245(b)(3) so as not to exceed the amount of gain which would be recognized to the partnership if section 1245 did not apply. Accordingly, the partnership does not recognize any gain under section 1245(a)(1) upon the distribution.

(iii) Immediately after the distribution, the amount of the adjustments reflected in the adjusted basis of the property is equal to $6,000 (that is, the potential section 1245 income of the partnership in respect of the property before the distribution, $6,000, minus the gain recognized by the partnership under section 751(b), zero). Accordingly, C's recomputed basis for the property is $16,000

(that is, adjusted basis, $10,000, plus adjustments reflected in the adjusted basis, $6,000).

Example 2. Assume the same facts as in example (1) except that the machine had been purchased by the partnership. Assume further that upon the distribution, the partnership recognizes $4,000 gain as ordinary income under section 751(b). Under section 1245(b)(3), gain to be taken into account under section 1245(a)(1) by the partnership is limited to $4,000. Immediately after the distribution, the amount of adjustments reflected in the adjusted basis of the property is $2,000 (that is, potential section 1245 income of the partnership, $6,000, minus gain recognized to the partnership under section 751(b), $4,000). Thus, if the adjusted basis of the machine in the hands of C were $11,333 (see, for example, the computation in paragraph (d)(2) of example (6) of paragraph (g) of § 1.751–1), the recomputed basis of the machine would be $13,333 ($11,333 plus $2,000).

(g) [Reserved]

(h) *Timber property subject to amortization under section 194*—(1) *In general.* For purposes of section 1245(a)(2), in determining the recomputed basis of property with respect to which a deduction under section 194 was allowed for any taxable year, a taxpayer shall not take into account amortization deductions claimed under section 194 to the extent such deductions are attributable to the amortizable basis (within the meaning of section 194(c)(2)) of the taxpayer acquired before the tenth taxable year preceding the taxable year in which gain with respect to the property is recognized.

(2) *Example.* The principles of paragraph (h)(1) of this section are illustrated by the following example:

Example: Assume A owns qualified timber property (as defined in section 194(c)(1)) with a basis of $30,000. In 1981, A incurs $12,000 of qualifying reforestation expenditures and elects to amortize the maximum $10,000 of such expenses under section 194. The $10,000 of deductions are taken during the 8-year period from 1981 to 1988. If A sells the property in 1990 for $60,000 a gain of $28,000 ($60,000—adjusted basis of $32,000) is recognized on the sale. Since the sale took place within 10 years of the taxable year in which the reforestation expenditures were made, $10,000 of the gain is treated as ordinary income, and the remaining $18,000 of gain would be capital gain, if it otherwise qualifies for capital gain treatment. In order to avoid ordinary income treatment of the gain attributable to the reforestation expenditures incurred in 1981, A would have to wait until 1992 to dispose of the property.

(i) *Effective/applicability date.* This section applies on and after January 19, 2017. For rules before January 19, 2017, see § 1.1245–4 as contained in 26 CFR part 1 revised as of April 1, 2016.

[T.D. 6832, 30 FR 8581, July 7, 1965, as amended by T.D. 7084, 36 FR 268, Jan. 8, 1971; T.D. 7207, 37 FR 20799, Oct. 14, 1972; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7927, 48 FR 55851, Dec. 16, 1983; T.D. 9811, 82 FR 6241, Jan. 19, 2017]

§ 1.1245–5 Adjustments to basis.

In order to reflect gain recognized under section 1245(a)(1), the following adjustments to the basis of property shall be made:

(a) *Property acquired in like kind exchange or involuntary conversion.* (1) If property is acquired in a transaction to which section 1245(b)(4) applies, its basis shall be determined under the rules of section 1031(d) or 1033(c).

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

Example: Jones exchanges property A, which is section 1245 property with an adjusted basis of $10,000, for property B, which has a fair market value of $9,000, and property C, which has a fair market value of $3,500, in a like kind exchange as to which no gain would be recognized under section 1031(a). Upon the exchange $2,500 gain is recognized under section 1245(a)(1), since property C is not section 1245 property. See section 1245(b)(4). Under the rules of section 1031(d), the basis of the properties received in the exchange is $12,500 (i.e., the basis of property transferred, $10,000, plus the amount of gain recognized, $2,500), of which the amount allocated to property C is $3,500 (the fair market value thereof), and the residue, $9,000, is allocated to property B.

(b) *Sections 1071 and 1081 transactions.* (1) If property is acquired in a transaction to which section 1071 and paragraph (e)(1) of § 1.1245–4 (relating to limitation for section 1071 transactions, etc.) apply, its basis shall be determined in accordance with the principles of paragraph (a) of this section.

(2) If the basis of property, other than section 1245 property, is reduced pursuant to either an election under section 1071 or the application of section 1082(a)(2), then the basis of the

property shall be increased to the extent of the gain recognized under section 1245(a)(1) by reason of the application of paragraph (e)(1)(iii) of § 1.1245–4.

[T.D. 6832, 30 FR 8584, July 7, 1965]

§ 1.1245–6 Relation of section 1245 to other sections.

(a) *General.* The provisions of section 1245 apply notwithstanding any other provision of subtitle A of the Code. Thus, unless an exception or limitation under section 1245(b) applies, gain under section 1245(a)(1) is recognized notwithstanding any contrary nonrecognition provision or income characterizing provision. For example, since section 1245 overrides section 1231 (relating to property used in the trade or business), the gain recognized under section 1245(a)(1) upon a disposition will be treated as ordinary income and only the remaining gain, if any, from the disposition may be considered as gain from the sale or exchange of a capital asset if section 1231 is applicable. See example (2) of paragraph (b)(2) of § 1.1245–1. For effect of section 1245 on basis provisions of the Code, see § 1.1245–5.

(b) *Nonrecognition sections overridden.* The nonrecognition provisions of subtitle A of the Code which section 1245 overrides include, but are not limited to, sections 267(d), 311(a), 336, 337, 501(a), 512(b)(5), and 1039. See section 1245(b) for the extent to which section 1245(a)(1) overrides sections 332, 351, 361, 371(a), 374(a), 721, 731, 1031, 1033, 1071, and 1081 (b)(1) and (d)(1)(A). For limitation on amount of adjustments reflected in adjusted basis of property disposed of by an organization exempt from income taxes (within the meaning of section 501(a)), see paragraph (a)(8) of § 1.1245–2.

(c) *Normal retirement of asset in multiple asset account.* Section 1245(a)(1) does not require recognition of gain upon normal retirements of section 1245 property in a multiple asset account as long as the taxpayer's method of accounting, as described in paragraph (e)(2) of § 1.167(a)–8 (relating to accounting treatment of asset retirements), does not require recognition of such gain.

(d) *Installment method.* (1) Gain from a disposition to which section 1245(a)(1) applies may be reported under the installment method if such method is otherwise available under section 453 of the Code. In such case, the income (other than interest) on each installment payment shall be deemed to consist of gain to which section 1245(a)(1) applies until all such gain has been reported, and the remaining portion (if any) of such income shall be deemed to consist of gain to which section 1245(a)(1) does not apply. For treatment of amounts as interest on certain deferred payments, see section 483.

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

Example: Jones contracts to sell an item of section 1245 property for $10,000 to be paid in 10 equal payments of $1,000 each, plus a sufficient amount of interest so that section 483 does not apply. He properly elects under section 453 to report under the installment method gain of $2,000 to which section 1245(a)(1) applies and gain of $1,000 to which section 1231 applies. Accordingly, $300 of each of the first 6 installment payments and $200 of the seventh installment payment is ordinary income under section 1245(a)(1), and $100 of the seventh installment payment and $300 of each of the last 3 installment payments is gain under section 1231.

(e) *Exempt income.* The fact that section 1245 provides for recognition of gain as ordinary income does not change into taxable income any income which is exempt under section 115 (relating to income of states, etc.), 892 (relating to income of foreign governments), or 894 (relating to income exempt under treaties).

(f) *Treatment of gain not recognized under section 1245.* Section 1245 does not prevent gain which is not recognized under section 1245 from being considered as gain under another provision of the Code, such as, for example, section 311(c) (relating to liability in excess of basis), section 341(f) (relating to collapsible corporations), section 357(c) (relating to liabilities in excess of basis), section 1238 (relating to amortization in excess of depreciation), or section 1239 (relating to gain from sale of depreciable property between certain related persons). Thus, for example, if section 1245 property, which has an adjusted basis of $1,000 and a recomputed basis of $1,500, is sold for $1,750 in

a transaction to which section 1239 applies, $500 of the gain would be recognized under section 1245(a)(1) and the remaining $250 of the gain would be treated as ordinary income under section 1239.

[T.D. 6832, 30 FR 8584, July 7, 1965, as amended by T.D. 7084, 36 FR 269, Jan. 8, 1971; T.D. 7400, 41 FR 5101, Feb. 4, 1976]

§ 1.1248–1 Treatment of gain from certain sales or exchanges of stock in certain foreign corporations.

(a) *In general.* (1) If a United States person (as defined in section 7701(a)(30)) recognizes gain on a sale or exchange after December 31, 1962, of stock in a foreign corporation, and if in respect of such person the conditions of subparagraph (2) of this paragraph are satisfied, then the gain shall be included in the gross income of such person as a dividend to the extent of the earnings and profits of such corporation attributable to such stock under § 1.1248–2 or 1.1248–3, whichever is applicable, which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, during the period or periods such stock was held (or was considered as held by reason of the application of section 1223, taking into account § 1.1248–8) by such person while such corporation was a controlled foreign corporation. See section 1248(a). See § 1.1248–8 for additional rules regarding the attribution of earnings and profits to the stock of a foreign corporation following certain nonrecognition transactions. For computation of earnings and profits attributable to such stock if there are any *lower tier* corporations, see paragraph (a) (3) and (4) of § 1.1248–2 or paragraph (a) of § 1.1248–3, whichever is applicable. In general, the amount of gain to be included in a person's gross income as a dividend under section 1248(a) shall be determined separately for each share of stock sold or exchanged. However, such determination may be made in respect of a block of stock if earnings and profits attributable to the block are computed under § 1.1248–2 or 1.1248–3. See paragraph (b) of § 1.1248–2 and paragraph (a)(5) of § 1.1248–3. For the limitation on the tax attributable to an amount included in an individual's gross income as a dividend under section 1248(a), see section 1248(b) and § 1.1248–4. For the treatment, under certain circumstances, of the sale or exchange of stock in a domestic corporation as the sale or exchange of stock held by the domestic corporation in a foreign corporation, see section 1248(e) and § 1.1248–6. For the nonapplication of section 1248 in certain circumstances, see section 1248(g) and paragraph (e) of this section. For the requirement that the person establish the amount of earnings and profits attributable to the stock sold or exchanged and, for purposes of section 1248(b), the amount of certain taxes, see section 1248(h) and § 1.1248–7.

(2) In respect of a United States person who sells or exchanges stock in a foreign corporation, the conditions referred to in subparagraph (1) of this paragraph are satisfied only if (i) such person owned, within the meaning of section 958(a), or was considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation at any time during the 5-year period ending on the date of the sale or exchange, and (ii) at such time such foreign corporation was a controlled foreign corporation (as defined in section 957).

(3) For purposes of subparagraph (2) of this paragraph, (i) a foreign corporation shall not be considered to be a controlled foreign corporation at any time before the first day of its first taxable year beginning after December 31, 1962, and (ii) the percentage of the total combined voting power of stock of a foreign corporation owned (or considered as owned) by a United States person shall be determined in accordance with the principles of section 951(b) and the regulations thereunder.

(4) For purposes of paragraph (a)(1) of this section, if a foreign partnership sells or exchanges stock of a corporation, the partners in such foreign partnership shall be treated as selling or exchanging their proportionate share of the stock of such corporation. Stock which is considered to have been sold or exchanged by a partner by reason of the application of this paragraph (a)(4)

shall for purposes of applying such sentence be treated as actually sold or exchanged by such partner.

(5) The application of this paragraph may be illustrated by the following examples:

Example 1. Corporation F is a foreign corporation which has outstanding 100 shares of one class of stock. F was a controlled foreign corporation for the period beginning on January 1, 1963, and ending on June 30, 1965, but was not a controlled foreign corporation at any time thereafter. On December 31, 1965, Brown, a United States person who has owned 15 shares of F stock since 1962, sells 7 of his 15 shares and recognizes gain with respect to each share sold. Since Brown owned stock representing at least 10 percent of the total combined voting power of F at a time during the 5-year period ending on December 31, 1965, while F was a controlled foreign corporation, the conditions of subparagraph (2) of this paragraph are satisfied. Therefore, section 1248(a) applies to the gain recognized by Brown to the extent of the earnings and profits attributable under §1.1248–3 to such shares.

Example 2. Assume the same facts as in example (1). Assume further that on February 1, 1970, Brown sells the remainder of his shares in F Corporation and recognizes gain with respect to each share sold. Even though Brown did not own stock representing at least 10 percent of the total combined voting power of F on February 1, 1970, nevertheless, in respect of each of the 8 shares of F stock which he sold on such date, the conditions of subparagraph (2) of this paragraph are satisfied since Brown owned stock representing at least 10 percent of such voting power at a time during the 5-year period ending on February 1, 1970, while F was a controlled foreign corporation. Therefore, section 1248(a) applies to the gain recognized by Brown to the extent of the earnings and profits attributable under §1.1248–3 to such shares. If, however, Brown had sold the reminder of his shares in F on July 1, 1970, since the last date on which Brown owned stock representing at least 10 percent of the total combined voting power of F while F was a controlled foreign corporation was June 30, 1965, a date which is not within the 5-year period ending July 1, 1970, the conditions of subparagraph (2) of this paragraph would not be satisfied and section 1248(a) would not apply.

Example 3. Corporation G, a foreign corporation created in 1950, has outstanding 100 shares of one class of stock and uses the calendar year as its taxable year. Corporation X, a United States person, owns 60 shares of G stock and has owned such stock since G was created. Corporation Y, a United States person, owned 15 shares of the G stock from 1950 until December 1, 1962, on which date it sold 10 of such shares. On December 31, 1963, Y sells its remaining 5 shares of the G stock and recognizes gain on the sale. Since G is not considered to be a controlled foreign corporation at any time before January 1, 1963, and since Y did not own stock representing at least 10 percent of the total combined voting power of G at any time on or after such date, the conditions of subparagraph (2) of this paragraph are not satisfied and section 1248(a) does not apply.

Example 4. (i) *Facts.* X, a domestic corporation, and Y, a foreign corporation that is not a controlled foreign corporation, are partners in foreign partnership Z. X has a 60% interest in Z, and Y has a 40% interest in Z. All parties are calendar year taxpayers. On January 1, year 1, Z forms foreign corporation H, a controlled foreign corporation that conducts a business in Country C. Z and H's functional currency is the United States dollar. In years 1 and 2, H did not earn subpart F income as defined in section 952(a). On December 31, year 2, Z sells all of the H stock for $600 when Z's adjusted basis in the stock is $100. Therefore, Z recognizes a gain of $500 on the sale, of which $300 is allocable to X as a 60% partner. At the time of the sale, H had $300 of earnings and profits, $180 of which (that is, 60% of $300) is attributable to X's 60% share of the H stock.

(ii) *Result.* Pursuant to section 1248(a) and paragraphs (a)(1) and (4) of this section, X and Y are treated as selling 60% and 40%, respectively, of the H stock. X includes in its gross income as a dividend $180 of the gain recognized on the sale. Because Y is a foreign corporation that is not a CFC, neither section 1248 nor section 964 applies to the sale of Y's 40% share of the H stock.

(iii) *Alternative facts.* If, instead, X owned its 60% interest in Z through another foreign partnership, the result would be the same.

(b) *Sale or exchange.* For purposes of section 1248(a), the term sale or exchange includes the receipt of a distribution which is treated as in exchange for stock under section 302(a) (relating to distributions in redemption of stock) or section 331(a) (relating to distributions in complete liquidation of a corporation). For purposes of section 1248(a), gain recognized by a shareholder under section 301(c)(3) in connection with a distribution of property by a corporation with respect to its stock shall be treated as gain from the sale or exchange of stock of such corporation.

(c) *Gain recognized.* Section 1248(a) applies to a sale or exchange of stock in a foreign corporation only if gain is recognized in whole or in part upon the

sale or exchange. Thus, for example, if a United States person exchanges stock in a foreign corporation and no gain is recognized on the exchange under section 332, 351, 354, 355, 356, or 361, taking into account the application of section 367, then no amount is includible in the gross income of the person as a dividend under section 1248(a). But see §§ 1.1248(f)–1 and 1.1248(f)–2, providing that a domestic distributing corporation must include in gross income amounts under section 1248(f) as a result of certain foreign stock distributed pursuant to section 337, 355(c)(1), or 361(c)(1) (in certain cases without regard to the amount of gain realized by the domestic distributing corporation in the distribution).

(d) *Credit for foreign taxes.* (1) If a domestic corporation includes an amount in its gross income as a dividend under section 1248(a) upon a sale or exchange of stock in a foreign corporation (referred to as a *first tier* corporation), and if on the date of the sale or exchange the domestic corporation owns directly at least 10 percent of the voting stock of the first tier corporation:

(i) The foreign tax credit provisions of sections 901 through 908 shall apply in the same manner and subject to the same conditions and limitations as if the first tier corporation on such date distributed to the domestic corporation as a dividend that portion of the amount included in gross income under section 1248(a) which does not exceed the earnings and profits of the first tier corporation attributable to the stock under § 1.1248–2 or § 1.1248–3, as the case may be, and

(ii) If on such date such first tier corporation owns directly 50 percent or more of the voting stock of a *lower tier* corporation described in paragraph (a)(3) of § 1.1248–2 or paragraph (a)(3) of § 1.1248–3, as the case may be (referred to as a *second tier* corporation), then the foreign tax credit provisions of sections 901 through 905 shall apply in the same manner and subject to the same conditions and limitations as if on such date (*a*) the domestic corporation owned directly that percentage of the stock in the second tier corporation which such domestic corporation is considered to own by reason of the application of section 958(a)(2), and (*b*) the second tier corporation had distributed to the domestic corporation as a dividend that portion of the amount included in gross income under section 1248(a) which does not exceed the earnings and profits of the second tier corporation attributable to such stock under § 1.1248–2 or § 1.1248–3, as the case may be.

(2) A credit shall not be allowed under subparagraph (1) of this paragraph in respect of taxes which are not actually paid or accrued. For the inclusion as a dividend in the gross income of a domestic corporation of an amount equal to the taxes deemed paid by such corporation under section 902(a)(1), see section 78.

(3) If subparagraph (1)(ii) of this paragraph applies, and if the amount included in gross income under section 1248(a) upon the sale or exchange of the stock in a first tier corporation described in subparagraph (1)(ii) of this paragraph is less than the sum of the earnings and profits of the first tier corporation attributable to such stock under § 1.1248–2 or § 1.1248–3, as the case may be, plus the earnings and profits of the second tier corporation attributable to such stock under § 1.1248–2 or § 1.1248–3, as the case may be, then the amount considered distributed to the domestic corporation as a dividend shall be determined by multiplying the amount included in gross income under section 1248(a) by:

(i) For purposes of applying subparagraph (1)(i) of this paragraph, the percentage that (*a*) the earnings and profits of the first tier corporation attributable to such stock under § 1.1248–2 or § 1.1248–3, as the case may be, bears to (*b*) the sum of the earnings and profits of the first tier corporation attributable to such stock under § 1.1248–2 or § 1.1248–3, as the case may be, plus the earnings and profits of the second tier corporation attributable to such stock under § 1.1248–2 or § 1.1248–3, as the case may be, and

(ii) For purposes of applying subparagraph (1)(ii) of this paragraph, the percentage that (*a*) the earnings and profits of the second tier corporation attributable to such stock under § 1.1248–2 or § 1.1248–3, as the case may be, bears to (*b*) the sum referred to in subdivision (i)(*b*) of this subparagraph.

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

Example 1. On June 30, 1964, domestic corporation D owns 10 percent of the voting stock of controlled foreign corporation X. On such date, D sells a share of X stock and includes $200 of the gain on the sale in its gross income as a dividend under section 1248(a). X does not own any stock of a lower tier corporation referred to in paragraph (a)(3) of § 1.1248–3. D uses the calendar year as its taxable year and instead of deducting foreign taxes under section 164, D chooses the benefits of the foreign tax credit provisions for 1964. If D had included $200 in its gross income as a dividend with respect to a distribution from X on June 30, 1964, the amount of the foreign income taxes paid by X which D would be deemed to have paid under section 902(a) in respect of such distribution would be $60. Thus, in respect of the $200 included in D's gross income as a dividend under section 1248(a), and subject to the applicable limitations and conditions of sections 901 through 905, D is entitled under this paragraph to a foreign tax credit of $60 for 1964.

Example 2. On June 30, 1965, domestic corporation D owns all of the voting stock of foreign corporation Y, and Y (the first tier corporation) owns all of the voting stock of foreign corporation Z (a second tier corporation). On such date, D sells a block of Y stock and includes $400 of the gain on the sale in its gross income as a dividend under section 1248(a). The earnings and profits attributable under § 1.1248–3 to the block are $600 from Y and $1,800 from Z. D uses the calendar year as its taxable year and instead of deducting foreign taxes under section 164, D chooses the benefits of the foreign tax credit provisions for 1965. For purposes of applying the foreign tax credit provisions, Y is considered under subparagraph (3) of this paragraph to have distributed to D a dividend of $100 ($400 × 600/2400) and Z is considered to have so distributed to D a dividend of $300 ($400 × 1800/2400). If D had included $100 in its gross income as a dividend with respect to a distribution from Y on June 30, 1965, the amount of foreign income taxes paid by Y which D would be deemed to have paid under section 902(a) in respect of such distribution is $80. If D had owned the stock in Z directly, and if D had included $300 in its gross income as a dividend with respect to a distribution from Z, the amount of foreign income taxes paid by Z which D would be deemed to have paid under section 902(a) in respect of such distribution is $120. Thus, in respect of the $400 included in D's gross income as a dividend under section 1248(a), and subject to the applicable limitations and conditions of sections 901 through 905, D is entitled under this paragraph to a foreign tax credit of $200 ($80 plus $120) for 1965.

(e) *Exceptions.* Under section 1248(g), this section and §§ 1.1248–2 through 1.1248–8 do not apply to:

(1) Distributions to which section 303 (relating to distributions in redemption of stock to pay death taxes) applies; or

(2) Any amount to the extent that the amount is, under any other provision of the Internal Revenue Code (Code), treated as—

(i) A dividend;

(ii) Gain from the sale of an asset which is not a capital asset; or

(iii) Gain from the sale of an asset held for not more than 1 year.

(f) *Installment method.* (1) Gain from a sale or exchange to which section 1248 applies may be reported under the installment method if such method is otherwise available under section 453 of the Code. In such case, the income (other than interest) on each installment payment shall be deemed to consist of gain which is included in gross income under section 1248 as a dividend until all such gain has been reported, and the remaining portion (if any) of such income shall be deemed to consist of gain to which section 1248 does not apply. For treatment of amounts as interest on certain deferred payments, see section 483.

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

Example: Jones contracts to sell stock in a controlled foreign corporation for $5,000 to be paid in 10 equal payments of $500 each, plus a sufficient amount of interest so that section 483 does not apply. He properly elects under section 453 to report under the installment method gain of $1,000 which is includible in gross income under section 1248 as a dividend and gain of $500 which is a long-term capital gain. Accordingly, $150 of each of the first 6 installment payments and $100 of the seventh installment payment are included in gross income under section 1248 as a dividend, and $50 of the seventh installment payment and $150 of each of the last 3 installment payments are long-term capital gain.

(g) *Effective/applicability date.* (1) The third sentence in paragraph (a)(1), paragraph (a)(4), and paragraph (a)(5), *Example 4*, of this section apply to income inclusions that occur on or after

July 30, 2007. A taxpayer may elect to apply paragraph (a)(4) of this section to income inclusions in open taxable years provided that it consistently applies paragraph (a)(4) of this section for income inclusions in the first year for which the election is applicable and in all subsequent years.

(2) Paragraph (b) of this section applies to distributions that occur on or after February 10, 2009.

(3) Paragraphs (c) and (e) of this section apply to transactions occurring on or after April 18, 2013.

[T.D. 6779, 29 FR 18130, Dec. 22, 1964, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7961, 49 FR 26225, June 27, 1984; T.D. 9345, 72 FR 41444, July 30, 2007; T.D. 9444, 74 FR 6828, Feb. 11, 2009; T.D. 9585, 77 FR 24381, Apr. 24, 2012; T.D. 9614, 78 FR 17041, Mar. 19, 2013]

§ 1.1248–2 Earnings and profits attributable to a block of stock in simple cases.

(a) *General*—(1) *Manner of computation*. For purposes of paragraph (a)(1) of § 1.1248–1, if a United States person sells or exchanges a block of stock (as defined in paragraph (b) of this section) in a foreign corporation, and if the conditions of paragraph (c) of this section are satisfied in respect of the block, then the earnings and profits attributable to the block which were accumulated in taxable years of the corporation beginning after December 31, 1962, during the period such block was held (or was considered to be held by reason of the application of section 1223, taking into account § 1.1248–8) by such person while such corporation was a controlled foreign corporation, shall be computed in accordance with the steps set forth in subparagraphs (2), (3), and (4) of this paragraph.

(2) *Step 1*. (i) For each taxable year of the corporation beginning after December 31, 1962, the earnings and profits accumulated for each such taxable year by the corporation shall be computed in the manner prescribed in paragraph (d) of this section, and (ii) for the period the person held (or is considered to have held by reason of the application of section 1223, taking into account § 1.1248–8) the block, the amount of earnings and profits attributable to the block shall be computed in the manner prescribed in paragraph (e) of this section.

(3) *Step 2*. If the conditions of paragraph (c)(5)(ii) of this section must be satisfied in respect of stock in a *lower tier* foreign corporation which such person owns within the meaning of section 958(a)(2), then (i) the earnings and profits accumulated for each such taxable year by such lower tier corporation shall be computed in the manner prescribed in paragraph (d) of this section, and (ii) for the period the person held (or is considered to have held by reason of the application of section 1223, taking into account § 1.1248–8) the block, the amount of earnings and profits of the lower tier corporation attributable to the block shall be computed in the manner prescribed in paragraph (e) of this section applied as if such person owned directly the percentage of such stock in such lower tier corporation which such person owns within the meaning of section 958(a)(2).

(4) *Step 3*. The amount of earnings and profits attributable to the block shall be the sum of the amounts computed under steps 1 and 2.

(b) *Block of stock*. For purposes of this section, the term *block of stock* means a group of shares sold or exchanged in one transaction, but only if:

(1) The amount realized, basis, and holding period are identical for each such share, and

(2) In case, during the period the person held (or is considered to have held by reason of the application of section 1223) such shares, any amount was included under section 951 in the gross income of the person (or another person) in respect of the shares, the excess under paragraph (e)(3)(ii) of this section (computed as if each share were a block) is identical for each such share.

(c) *Conditions to application*. This section shall apply only if the following conditions are satisfied:

(1)(i) On each day of the period during which the block of stock was held (or is considered as held by reason of the application of section 1223) by the person during taxable years of the corporation beginning after December 31, 1962, the corporation is a controlled foreign corporation, and

(ii) On no such day is the corporation a foreign personal holding company (as

defined in section 552) or a foreign investment company (as defined in section 1246(b)).

(2) The corporation had only one class of stock, and the same number of shares of such stock were outstanding, on each day of each taxable year of the corporation beginning after December 31, 1962, any day of which falls within the period referred to in subparagraph (1) of this paragraph.

(3) For each taxable year referred to in subparagraph (2) of this paragraph, the corporation is not a less developed country corporation (as defined in section 902(d)).

(4) For each taxable year referred to in subparagraph (2) of this paragraph, the corporation does not make any distributions out of its earnings and profits other than distributions which, under section 316 (as modified by section 959), are considered to be out of earnings and profits accumulated in taxable years beginning after December 31, 1962, during the period such person held (or is considered to have held by reason of the application of section 1223, taking into account §1.1248–8) the block while such corporation was a controlled foreign corporation.

(5)(i) If (*a*) on the date of the sale or exchange such person, by reason of his ownership of such block, owns within the meaning of section 958(a)(2) stock in another foreign corporation (referred to as a *lower tier* corporation), and (*b*) the conditions of paragraph (a)(2) of §1.1248–1 would be satisfied by such person in respect of such stock in the lower tier corporation if such person were deemed to have sold or exchanged such stock in the lower tier corporation on the date he actually sold or exchanged such block in the first tier corporation, then the conditions of subdivision (ii) of this subparagraph must be satisfied.

(ii) In respect of stock in such lower tier corporation, (*a*) the conditions set forth in subparagraphs (1) through (4) of this paragraph (applied as if such person owned directly such stock in such lower tier corporation) must be met and (*b*) such person must own within the meaning of section 958(a)(2) the same percentage of the shares of such stock on each day which falls within the period referred to in subparagraph (1) of this paragraph.

(d) *Earnings and profits accumulated for a taxable year*—(1) *General.* For purposes of this section, the earnings and profits accumulated for a taxable year of a foreign corporation shall be the earnings and profits for such year computed in accordance with the rules prescribed in §1.964–1 (relating to determination of earnings and profits for a taxable year of a controlled foreign corporation) and reduced by any distributions therefrom. If the stock in the corporation is sold or exchanged before any action is taken by or on behalf of the corporation under paragraph (c) of §1.964–1, the computation of earnings and profits under §1.964–1 for purposes of this section shall be made as if no elections had been made and no accounting method had been adopted.

(2) *Special rules.* (i) The earnings and profits of the corporation accumulated:

(*a*) For any taxable year beginning before January 1, 1967 (computed without any reduction for distributions), shall not include the excess of any item includible in gross income of the foreign corporation under section 882(b) as gross income derived from sources within the United States, and

(*b*) For any taxable year beginning after December 31, 1966 (computed without any reduction for distributions), shall not include the excess of any item includible in gross income of the foreign corporation under section 882(b)(2) as income effectively connected for that year with the conduct by such corporation of a trade or business in the United States, whether derived from sources within or from sources without the United States,

Over any deductions allocable to such item under section 882(c). However, if the sale or exchange of stock in the foreign corporation by the United States person occurs before January 1, 1967, the provisions of (*a*) of this subdivision apply with respect to such sale or exchange even though the taxable year begins after December 31, 1966. See section 1248(d)(4). Any item which is required to be excluded from gross income, or which is taxed at a reduced rate, under an applicable treaty obligation of the United States shall not be

excluded under this subdivision from earnings and profits accumulated for a taxable year (computed without any reduction for distributions).

(ii) If a foreign corporation adopts a plan of complete liquidation in a taxable year of the corporation beginning after December 31, 1962, and if because of the application of section 337(a) gain or loss would not be recognized by the corporation from the sale or exchange of property if the corporation were a domestic corporation, then the earnings and profits of the corporation accumulated for the taxable year (computed without any reduction for distributions) shall be determined without regard to the amount of such gain or loss. See section 1248(d)(2). For the nonapplication of section 337(a) to a liquidation by a collapsible corporation (as defined in section 341) and to certain other liquidations, see section 337(c).

(e) *Earnings and profits attributable to block*—(1) *General*. Except as provided in subparagraph (3) of this paragraph, the earnings and profits attributable to a block of stock of a controlled foreign corporation for the period a United States person held (or is considered to have held by reason of the application of section 1223, taking into account §1.1248–8) the block are an amount equal to:

(i) The sum of the earnings and profits accumulated for each taxable year of the corporation beginning after December 31, 1962 (computed under paragraph (d) of this section) during such period, multiplied by

(ii) The percentage that (*a*) the number of shares in the block, bears to (*b*) the total number of shares of the corporation outstanding during such period.

(2) *Special rule*. For purposes of computing the sum referred to in subparagraph (1)(i) of this paragraph, in case the block was held (or is considered as held by reason of the application of section 1223, taking into account §1.1248–8) during a taxable year beginning after December 31, 1962, but not on each day of such taxable year, there shall be included in such sum only that portion which bears the same ratio to (i) the total earnings and profits for such taxable year (computed under paragraph (d) of this section), as (ii) the number of days during such taxable year the block was held (or is considered as so held), bears to (iii) the total number of days in such taxable year.

(3) *Amounts included in gross income under section 951*. (i) If, during the period the person held (or is considered to have held by reason of the application of section 1223, taking into account §1.1248–8) the block, any amount was included under section 951 in the gross income of such person (or of another person whose holding of the stock sold or exchanged is, by reason of the application of section 1223, attributed to such person) in respect of the block, then the earnings and profits attributable to the block for such period shall be an amount equal to (*a*) the earnings and profits attributable to the block which would have been computed under subparagraph (1) of this paragraph if this subparagraph did not apply, reduced by (*b*) the excess computed under subdivision (ii) of this subparagraph. See section 1248(d)(1).

(ii) The excess computed under this subdivision is the excess (if any) of (*a*) amounts included under section 951 in the gross income of such person (or such other person) in respect of the block during such period, over (*b*) the portion of such amounts which, in any taxable year of such person (or such other person), resulted in an exclusion from the gross income of such person (or such other person) under section 959(a)(1) (relating to exclusion from gross income of distributions of previously taxed earnings and profits).

(iii) This subparagraph shall apply notwithstanding an election under section 962 by such person to be subject to tax at corporate rates.

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

Example 1. On May 26, 1965, Green, a United States person, purchases at its fair market value a block of 25 of the 100 outstanding shares of the only class of stock of controlled foreign corporation F. He sells the block on January 1, 1968. In respect of the block, Green did not include any amount in his gross income under section 951. F uses the calendar year as its taxable year and does not own stock in any lower tier corporation referred to in paragraph (c)(5)(i) of this section. All of the conditions of paragraph (c) of

this section are satisfied in respect of the block. The earnings and profits accumulated by F (computed under paragraph (d) of this section) are $10,000 for 1965, $13,000 for 1966, and $11,000 for 1967. The earnings and profits of F attributable to the block are $7,500, determined as follows:

Sum of earnings and profits accumulated by F during period block was held:	
For 1965 (219/365 × $10,000)	$6,000
For 1966	$13,000
For 1967	$11,000
Sum	$30,000
Multiplied by:	
Number of shares in block (25), divided by total number of shares outstanding (100)	25%
Earnings and profits attributable to block	$7,500

Example 2. Assume the same facts as in example (1) except that in respect of the block Green includes in his gross income under section 951 the total amount of $2,800 for 1965 and 1966, and because of such inclusion the amount of $2,800 which was distributed to Green by F on January 15, 1967, is excluded from his gross income under section 959(a)(1). Accordingly, the earnings and profits of F attributable to the block are $7,000, determined as follows:

Earnings and profits attributable to the block, as computed in example (1)	$7,500
Minus:	
Excess of amount included in Green's gross income under section 951 ($2,800), over portion thereof which resulted in an exclusion under section 959(a)(1) ($2,300)	500
Earnings and profits attributable to block	7,000

Example 3. Assume the same facts as in example (1) except that on each day beginning on January 1, 1966 (the date controlled foreign corporation G was organized) through January 1, 1968, F owns 80 of the 100 outstanding shares of the only class of G stock. Since, by reason of his ownership of 25 shares of F stock, Green owns within the meaning of section 958(a)(2) the equivalent of 20 shares of G stock (25/100 of 80 shares), G is a lower tier corporation referred to in paragraph (c)(5)(i)(*a*) of this section. If Green had sold the 20 shares of G stock on January 1, 1968, the date he actually sold the block of F stock, the conditions of paragraph (a)(2) of § 1.1248–1 would be satisfied in respect of the G stock, and, accordingly, the conditions of paragraph (c)(5)(ii) of this section must be satisfied. Assume further that such conditions are satisfied, that G uses the calendar year as its taxable year, and that the earnings and profits accumulated by G (computed under paragraph (d) of this section) are $19,000 for 1966 and $21,000 for 1967. The earnings and profits of F and of G attributable to the block are $15,500, determined as follows:

Sum of earnings and profits accumulated by G for period Green owned G stock within the meaning of section 958(a)(2) ($19,000 plus $21,000)	$40,000
Multiplied by:	
Number of G shares deemed owned within the meaning of section 958(a)(2) by Green (20), divided by total number of G shares outstanding (100)	20%
Earnings and profits of G attributable to block	$8,000
Earnings and profits of F attributable to block, as determined in example (1)	$7,500
Total earnings and profits attributable to block	$15,000

[T.D. 6779, 29 FR 18131, Dec. 22, 1964, as amended by T.D. 7293, 38 FR 32803, Nov. 28, 1973; T.D. 9345, 72 FR 41445, July 30, 2007]

§ 1.1248–3 Earnings and profits attributable to stock in complex cases.

(a) *General*—(1) *Manner of computation.* For purposes of paragraph (a)(1) of § 1.1248–1, if a United States person sells or exchanges stock in a foreign corporation, and if the provisions of § 1.1248–2 do not apply, then the earnings and profits attributable to the stock which were accumulated in taxable years of the corporation beginning after December 31, 1962, during the period or periods such stock was held (or was considered to be held by reason of the application of section 1223, taking into account § 1.1248–8) by such person while such corporation was a controlled foreign corporation, shall be computed in accordance with the steps set forth in subparagraphs (2), (3), and (4) of this paragraph.

(2) *Step 1.* For each taxable year of the corporation beginning after December 31, 1962, (i) the earnings and profits accumulated for such taxable year by the corporation shall be computed in the manner prescribed in paragraph (b) of this section, (ii) the person's *tentative ratable share* of such earnings and profits shall be computed in the manner prescribed in paragraph (c) or (d) (whichever is applicable) of this section, and (iii) the person's *ratable share* of such earnings and profits shall be computed by adjusting the tentative ratable share in the manner prescribed in paragraph (e) of this section.

(3) *Step 2.* If the provisions of paragraph (f) of this section (relating to earnings and profits of *lower tier* foreign corporations) apply, the amount

of the person's ratable share of the earnings and profits accumulated by each *lower tier* corporation attributable to any such taxable year (i) shall be computed in the manner prescribed by paragraph (f) of this section, and (ii) shall be added to such person's ratable share for such taxable year determined in step 1.

(4) *Step 3.* The amount of earnings and profits attributable to the share shall be the sum of the ratable shares computed for each such taxable year in the manner prescribed in steps 1 and 2.

(5) *Share or block.* In general, the computation under this paragraph shall be made separately for each share of stock sold or exchanged, except that if a group of shares constitute a block of stock the computation may be made in respect of the block. For purposes of this section, the term *block of stock* means a group of shares sold or exchanged in one transaction, but only if (i) the amount realized, basis, and holding period are identical for each such share, and (ii) the adjustments (if any) under paragraphs (e) and (f)(5) of this section of the tentative ratable shares would be identical for each such share if such adjustments were computed separately for each such share.

(6) *Deficit in earnings and profits.* For purposes of this section and §§ 1.1248–2 through 1.1248–8, in respect of a taxable year, the term *earnings and profits accumulated* for a taxable year (but only if computed under paragraph (b) of this section) includes a deficit in earnings and profits accumulated for such taxable year. Similarly, a tentative ratable share, or a ratable share, may be a deficit.

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

Example 1. On December 31, 1967, Brown sells 10 shares of stock in foreign corporation X, which uses the calendar year as its taxable year. The 10 shares constitute a block of stock under subparagraph (5) of this paragraph. Under step 1, Brown's ratable shares of the earnings and profits of X attributable to the block are as follows:

Taxble year of X	Ratable shares
1963	$100
1964	150
1965	[1] 50
1966	50
1967	100
Sum	350

[1] Deficit.

The amount of the earnings and profits attributable to such block under step 3 is $350.

Example 2. Assume the same facts as in example (1), except that in respect of X there are *lower tier* corporations Y and Z to which the provisions of paragraph (f) of this section apply. Brown's ratable shares of the earnings and profits of X, Y, and Z attributable to the block under steps 1 and 2 for each taxable year of X are as follows:

Taxable year of X	Ratable shares			
	X	Y	Z	Total
1963	$100	$40	$20	$160
1964	150	40	−60	130
1965	−50	30	50	30
1966	50	50	30	130
1967	100	−40	40	100
Sum	350	120	80	550

The amount of the earnings and profits attributable to such block under step 3 is $550.

(b) *Earnings and profits accumulated for a taxable year*—(1) *General.* For purposes of this section, the earnings and profits accumulated for a taxable year of a foreign corporation shall be the earnings and profits for such year, computed in accordance with the rules prescribed in § 1.964–1 (relating to determination of earnings and profits for a taxable year of a controlled foreign corporation), except that (i) the special rules of subparagraph (2) of this paragraph shall apply, and (ii) adjustments shall be made under subparagraph (3) of this paragraph for distributions made by the corporation during such taxable year. If the stock in the corporation is sold or exchanged before any action is taken by or on behalf of the corporation under paragraph (c) of § 1.964–1, the computation of earnings and profits under § 1.964–1 for purposes of this section shall be made as if no elections had been made and no accounting method had been adopted. The amount of earnings and profits accumulated for a taxable year of a foreign corporation, as computed under this paragraph, is not necessarily the same amount as the earnings and profits of the taxable year computed under section 316(a)(1)

or paragraph (d) of § 1.1248–2. Thus, for example, if a distribution with respect to stock is in excess of the amount of earnings and profits of the taxable year computed under section 316(a)(2), such excess is treated under section 316(a)(2), or paragraph (d) of § 1.1248–2 as made out of any earnings and profits accumulated in prior taxable years, whereas the amount of such excess may create, or increase, a deficit in the earnings and profits accumulated for the taxable year as computed under this paragraph. See subparagraph (3) of this paragraph.

(2) *Special rules.* (i) The earnings and profits of the corporation accumulated:

(*a*) For any taxable year beginning before January 1, 1967, shall not include the excess of any item includible in gross income of the foreign corporation under section 882(b) as gross income derived from sources within the United States, and

(*b*) For any taxable year beginning after December 31, 1966, shall not include the excess of any item includible in gross income of the foreign corporation under section 882(b)(2) as income effectively connected for that year with the conduct by such corporation of a trade or business in the United States, whether derived from sources within or from sources without the United States,

Over any deductions allocable to such item under section 882(c). However, if the sale or exchange of stock in the foreign corporation by the U.S. person occurs before January 1, 1967, the provisions of (*a*) of this subdivision apply with respect to such sale or exchange even though the taxable year begins after December 31, 1966. See section 1248(d)(4). Any item which is required to be excluded from gross income, or which is taxed at a reduced rate, under an applicable treaty obligation of the United States shall not be excluded under this subdivision from earnings and profits accumulated for a taxable year.

(ii) If a foreign corporation adopts a plan of complete liquidation in a taxable year of the corporation beginning after December 31, 1962, and if because of the application of section 337(a) gain or loss would not be recognized by the corporation from the sale or exchange of property if the corporation were a domestic corporation, then the earnings and profits of the corporation accumulated for the taxable year shall be determined without regard to the amount of such gain or loss. See section 1248(d)(2). For the nonapplication of section 337(a) to a liquidation by a collapsible corporation (as defined in section 341) and to certain other liquidations, see section 337(c).

(3) *Adjustment for distributions.* (i) The earnings and profits of a foreign corporation accumulated for a taxable year (computed without regard to this subparagraph) shall be reduced (if necessary below zero so as to create a deficit), or a deficit in such earnings and profits shall be increased, by the amount of the distributions (other than in redemption of stock under section 302(a) or 303) made by the corporation in respect of its stock during such taxable year (*a*) out of such earnings and profits, or (*b*) out of earnings and profits accumulated for prior taxable years beginning after December 31, 1962 (computed under this paragraph). Except for purposes of applying this subparagraph, the application of the preceding sentence shall not affect the amount of earnings and profits accumulated for any such prior taxable year.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example 1. X Corporation, which uses the calendar year as its taxable year, was organized on January 1, 1965, and was a controlled foreign corporation on each day of 1965. The amount of X's earnings and profits accumulated for 1965 (computed under this paragraph without regard to the adjustment for distributions under this subparagraph) is $400,000, of which $100,000 is distributed by X as dividends during 1965. The amount of X's earnings and profits accumulated for 1965 (computed under this paragraph) is $300,000 (that is, $400,000 minus $100,000). The result would be the same even if X was not a controlled foreign corporation on each day of 1965.

Example 2. Assume the same facts as in example (1). Assume further that the amount of X's earnings and profits accumulated for 1966 (computed under this paragraph without regard to the adjustment for distributions under this subparagraph) is $150,000, and that

X distributes the amount of $260,000 as dividends during 1966. Since $150,000 of the distribution is from earnings and profits accumulated for 1966 (computed without regard to the adjustment for distributions under this subparagraph), and since $110,000 is from earnings and profits accumulated for 1965, the earnings and profits of X accumulated for 1966 are a deficit of $110,000 (that is, $150,000 minus $260,000). However, the earnings and profits accumulated for 1965 are still $300,000 for purposes of computing in the manner prescribed in paragraph (c) of this section a person's tentative ratable share.

(c) *Tentative ratable share if earnings and profits accumulated for a taxable year not less than zero*—(1) *General rule.* For purposes of paragraph (a)(2)(ii) of this section, in respect of a share (or block) of stock in a foreign corporation, if the amount of the earnings and profits accumulated for a taxable year of the corporation (computed under paragraph (b) of this section), beginning after December 31, 1962, is not less than zero, then the person's tentative ratable share for such taxable year shall be equal to:

(i)(*a*) Such amount (if the computation is made in respect of a block, multiplied by the number of shares in the block), divided by (*b*) the number of shares in the corporation outstanding, or deemed under subparagraph (2) of this paragraph to be outstanding, on each day of such taxable year, multiplied by

(ii) The percentage that (*a*) the number of days in such taxable year of the corporation during the period the person held (or was considered to have held by reason of the application of section 1223, taking into account § 1.1248–8) the share (or block) while the corporation was a controlled foreign corporation, bears to (*b*) the total number of days in such taxable year.

(2) *Shares deemed outstanding for a taxable year.* For purposes of this section and §§ 1.1248–4 through 1.1248–7, if the number of shares of stock in a foreign corporation outstanding on each day of a taxable year of the corporation is not constant, then the number of such shares deemed outstanding on each such day shall be the sum of the fractional amounts in respect of each share outstanding on any day of the taxable year. The fractional amount in respect of a share shall be determined by dividing (i) the number of days in the taxable year during which such share was outstanding (excluding the day the share became outstanding, but including the day the share ceased to be outstanding), by (ii) the total number of days in such taxable year.

(3) *Examples.* The application of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. On each day of 1964, S owns a block consisting of 30 of the 100 shares of the only class of stock outstanding in F Corporation, and on each such day F is a controlled foreign corporation. F uses the calendar year as its taxable year and F's earnings and profits accumulated for 1964 (computed under paragraph (b) of this section) are $10,000. S's tentative ratable share with respect to the block is $3,000, computed as follows:

Earnings and profits accumulated for taxable year	$10,000
Multiplied by:	
Number of shares in block (30), divided by number of shares outstanding (100)	30%
Multiplied by:	
Number of days in 1964 S held block while F was a controlled foreign corporation (365), divided by number of days in 1964 (365)	100%
Tentative ratable share for block	$3,000

Example 2. On December 31, 1964, X Corporation, a controlled foreign corporation which uses the calendar year as its taxable year, had 100 shares of one class of stock outstanding, 15 of which were owned by T. T's 15 shares were redeemed by X on March 14, 1965. On December 31, 1965, in addition to the remaining 85 shares, 10 new shares of stock (which were issued on May 26, 1965) were outstanding. Thus, during 1965, 15 shares were outstanding for 73 days, 10 for 219 days, and 85 for 365 days. The earnings and profits (computed under paragraph (b) of this section) accumulated for X's taxable year ending on December 31, 1965, are $18,800. T's tentative ratable share with respect to one share of stock is $40, computed as follows:

Earnings and profits accumulated for taxable year		$18,800
Divided by:		
Number of shares deemed outstanding each day of 1965:.		
15 for 73 days (15 × 73/365)	3	
10 for 219 days (10 × 219/365)	6	
85 for 365 days (35 × 365/365)	85	
Total number of shares deemed outstanding each day of 1965		94
Earnings and profits accumulated per share		$200

Multiplied by:	
Number of days in 1965 T held his share while X was a controlled foreign corporation (73), divided by number of days in 1965 (365)	20%
T's tentative ratable share per share of stock	$40

Example 3. Assume the same facts as in example (2) except that X was not a controlled foreign corporation after January 31, 1965. T's tentative ratable share with respect to one share of stock for 1965 is $17, computed as follows:

Earnings and profits accumulated per share, determined in example (2)	$200
Multiplied by:	
Number of days in 1965 T held X stock while X was a controlled foreign corporation (31), divided by number of days in 1965 (365)	8.5%
Tentative ratable share	$17

(4) *More than one class of stock.* If a foreign corporation for a taxable year has more than one class of stock outstanding, then before applying subparagraphs (1) and (2) of this paragraph the earnings and profits accumulated for the taxable year of the corporation (computed under paragraph (b) of this section) shall be allocated to each class of stock in accordance with the principles of paragraph (e) (2) and (3) of § 1.951–1, applied as if the corporation were a controlled foreign corporation on each day of such taxable year.

(d) *Tentative ratable share if deficit in earnings and profits accumulated for taxable year*—(1) *General rule.* For purposes of paragraph (a)(2)(ii) of this section, in respect of a share (or block) of stock in a foreign corporation, if there is a deficit in the earnings and profits accumulated for a taxable year of the corporation (computed under paragraph (b) of this section) beginning after December 31, 1962, the person's tentative ratable share for such taxable year shall be an amount equal to the sum of the partial tentative ratable shares computed under subparagraphs (2) and (3) of this paragraph.

(2) *Operating deficit.* The partial tentative ratable share under this subparagraph is computed in 2 steps. First, compute (under paragraph (b) of this section without regard to the adjustment for distributions under subparagraph (3) thereof) the deficit (if any) in earnings and profits accumulated for such taxable year. Second, compute the partial tentative ratable share in the same manner as the tentative ratable share for such taxable year would be computed under paragraph (c) of this section if such deficit were the amount referred to in paragraph (c)(1)(i)(*a*) of this section.

(3) *Deficit from distributions.* The partial tentative ratable share under this subparagraph is computed in 2 steps. First, compute and treat as a deficit only that portion of the adjustment for distributions under paragraph (b)(3) of this section for such taxable year which is attributable under subparagraph (4) of this paragraph to distributions out of earnings and profits accumulated during prior taxable years of the corporation beginning after December 31, 1962, during the period or periods the corporation was a controlled foreign corporation and the share (or block) of stock was owned by a United States shareholder (as defined in section 951(b) and the regulations thereunder). Second, compute the partial tentative ratable share for such taxable year in the same manner as the tentative ratable share for such taxable year would be computed under paragraph (c) of this section if (i) such deficit were the amount referred to in paragraph (c)(1)(i)(*a*) of this section, and (ii) the corporation were a controlled foreign corporation on each day of such taxable year.

(4) *Order of distributions.* For purposes of applying subparagraph (3) of this paragraph only, the adjustment for distributions under paragraph (b)(3) of this section for a taxable year of a foreign corporation shall be treated as attributable first to distributions of earnings and profits for the taxable year (computed under paragraph (b) of this section without regard to such adjustment) to the extent thereof, and then to distributions out of the most recent of earnings and profits accumulated during prior taxable years beginning after December 31, 1962 (computed under paragraph (b) of this section). If the foreign corporation was a controlled foreign corporation during a prior taxable year for a period or periods which was only part of such prior taxable year, then for purposes of the preceding sentence (i) such taxable year shall be divided into periods the

corporation was or was not a controlled foreign corporation, (ii) distributions of the earnings and profits accumulated during such prior taxable year shall be considered made from the most recent period first, and (iii) the earnings and profits accumulated during such prior taxable year shall be allocated to a period during such year in the same proportion as the number of days in the period bears to the number of days in such year. Except for purposes of applying subparagraph (3) of this paragraph, the application of this subparagraph shall not affect the amount of earnings and profits accumulated for any such prior taxable year (computed under paragraph (b) of this section).

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

Example 1. On each day of 1965 X Corporation, which uses the calendar year as its taxable year, was a controlled foreign corporation having 100 shares of one class of stock outstanding, a block of 25 of which were owned by T, who acquired them in 1962 and sold them in 1967. The deficit in X's earnings and profits accumulated for 1965 (computed under paragraph (b) of this section without regard to the adjustment for distributions under subparagraph (3) thereof) is $100,000, and thus in respect of the block T's partial tentative ratable share computed under subparagraph (2) of this paragraph is a deficit of $25,000 (that is, $100,000 × 25/100). During 1965 X does not make any distributions in respect of its stock, and thus in respect of the block T's partial tentative ratable share computed under subparagraph (3) of this paragraph is zero. Accordingly, T's tentative ratable share in respect of the block of X stock for 1965 is a deficit of $25,000. If, however, X was a controlled foreign corporation for only 292 days during 1965, T's tentative ratable share in respect of the block for 1965 would be a deficit of $20,000 (that is, $25,000 × 292/365).

Example 2. (i) Assume the same facts as in example (1) except that at no time during 1965 is X a controlled foreign corporation and that during 1965 X distributes $80,000 with respect to its stock. Assume further that X was a controlled foreign corporation on each day of 1964, but only for the first 146 days of 1963, and that X's earnings and profits accumulated for prior taxable years computed under paragraph (b) of this section are $70,000 for 1964 and $20,000 for 1963.

(ii) Since X was not a controlled foreign corporation on any day of 1965, in respect of the block T's partial tentative ratable share computed under subparagraph (2) of this paragraph is zero.

(iii) The partial tentative ratable share under subparagraph (3) of this paragraph is computed in the following manner: For 1965 the adjustment for distributions under paragraph (b)(3) of this section is $80,000. Under subparagraph (4) of this paragraph $70,000 of such adjustment is attributable to the distribution of all of the earnings and profits accumulated during 1964, on every day of which X was a controlled foreign corporation, and $10,000 of the adjustment is attributable to the distribution of $10,000 of the earnings and profits accumulated for 1963. The portion of the earnings and profits accumulated by X in 1963 attributable to the first 146 days in 1963 during which X was a controlled foreign corporation is $8,000 (that is, $20,000 × 146/365), and the portion attributable to the period in 1963 during which X was not a controlled foreign corporation is $12,000 (that is, $20,000 × 219/365). Under subparagraph (4)(ii) of this paragraph, the distribution in 1965 of $10,000 of earnings and profits accumulated during 1963 is attributable to the more recent period in 1963, that is, the period X was not a controlled foreign corporation. Accordingly, the portion of the adjustment for distributions under paragraph (b)(3) of this section attributable to earnings and profits accumulated during periods X was a controlled foreign corporation is $70,000, and in respect of the block T's partial tentative ratable share under subparagraph (3) of this paragraph is a deficit of $17,500 (that is, $70,000 × 25/100).

(iv) T's tentative ratable share in respect of the block of X stock for 1965 is a deficit of $17,500 (that is, the sum of the partial tentative ratable share for the block computed under subparagraph (2) of this paragraph, zero, plus the partial tentative ratable share for the block computed under subparagraph (3) of this paragraph, a deficit of $17,500).

(v) Assume that X had 100 shares of one class of stock outstanding on each day of 1964 and 1963. Notwithstanding the distributions in 1965 of earnings and profits accumulated during 1964 and 1963 (computed under paragraph (b) of this section), nevertheless, in respect of the block T's tentative ratable share for 1964 is $17,500 (that is, earnings and profits accumulated during 1964 so computed of $70,000, multiplied by 25 shares/100 shares) and in respect of the block T's tentative ratable share for 1963 is $2,000 (that is, earnings and profits accumulated during 1963 so computed of $20,000, multiplied by 25 shares/100 shares, and multiplied by the percentage that the number of days in 1963 on which X was a controlled foreign corporation bears to the total number of days in 1963, 146/365).

Example 3. Assume the same facts as in example (2) except that X was a controlled foreign corporation on each day of 1965. The tentative ratable share with respect to the

block of stock for 1965 is a deficit of $42,500, that is, the sum of the partial tentative ratable share under subparagraph (2) of this paragraph (as determined in example (1)), a deficit of $25,000, plus the partial tentative ratable share under subparagraph (3) of this paragraph (as determined in example (2)), a deficit of $17,500.

(6) *More than one class of stock.* If a foreign corporation for a taxable year has more than one class of stock outstanding, then before applying subparagraph (1) of this paragraph the earnings and profits accumulated for the taxable year of the corporation (computed under paragraph (b) of this section) shall be allocated to each class of stock in accordance with the principles of paragraph (e) (2) and (3) of § 1.951–1, applied as if the corporation were a controlled foreign corporation on each day of such taxable year.

(e) *Ratable share of earnings and profits accumulated for a taxable year*—(1) *In general.* For purposes of paragraph (a)(2)(iii) of this section, in respect of a share (or block) of stock in a foreign corporation, the person's ratable share of the earnings and profits accumulated for a taxable year beginning after December 31, 1962, shall be an amount equal to the tentative ratable share computed under paragraph (c) or (d) (as the case may be) of this section, adjusted in the manner prescribed in subparagraphs (2) through (6) of this paragraph.

(2) *Amounts included in gross income under section 951.* (i) In respect of a share (or block) of stock in a foreign corporation, a person's tentative ratable share for a taxable year of the corporation (computed under paragraph (c) of this section) shall be reduced (but not below zero) by the excess of (*a*) the amount, if any, included (in respect of such corporation for such taxable year) under section 951 in the gross income of such person or (during the period such share, or block, was considered to be held by such person by reason of the application of section 1223, taking into account § 1.1248–8) in the gross income of any other person who held such share (or block), over (*b*) the portion of such amount which, in any taxable year of such person or such other person, resulted in an exclusion from the gross income of such person or such other person of an amount under section 959(a)(1) (relating to exclusion from gross income of distributions of previously taxed earnings and profits). See section 1248(d)(1). This subdivision shall apply notwithstanding an election under section 962 by such person to be subject to tax at corporate rates.

(ii) The application of this subparagraph may be illustrated by the following example:

Example: On December 31, 1975, Brown sells one share of stock in X Corporation, a controlled foreign corporation which has never been a less developed country corporation (as defined in section 902(d)). Both Brown and X use the calendar year as the taxable year. In respect of his share, Brown's tentative ratable share for 1971 (computed under paragraph (c) of this section) is $35. In respect of his share, Brown included $4 in his gross income for 1971 under section 951, and the amount of $3, which was distributed to him by X on January 15, 1972, is excluded from Brown's gross income under section 959(a)(1). In respect of the stock, Brown's ratable share for 1971 is $34, determined as follows:

Tentative ratable share	$35
Minus:	
Excess of amount of tentative ratable share included in Brown's gross income under section 951 ($4), over portion thereof which resulted in exclusion under section 959(a)(1) ($3)	1
Ratable share	34

(3) *Amounts included in gross income under section 551.* In respect of a share (or block) of stock in a foreign corporation, a person's tentative ratable share for a taxable year of the corporation (computed under paragraph (c) of this section) shall be reduced (but not below zero) by the amount, if any, included (in respect of such corporation for such taxable year) under section 551 in the gross income of such person or (during the period such share, or block, was considered to be held by such person by reason of the application of section 1223, taking into account § 1.1248–8) in the gross income of any other person who held such share (or block).

(4) *Less developed country corporations.* (i) If the foreign corporation was a less developed country corporation as defined in section 902(d) for a taxable year of the corporation, and if the person who sold or exchanged a share (or block) of stock in such corporation satisfies the requirements of paragraph (a) of § 1.1248–5 in respect of such stock, then his ratable share for such taxable

year shall be zero. See section 1248(d)(3).

(ii) The application of this subparagraph may be illustrated by the following example:

Example: Assume the same facts as in the example in subparagraph (2)(ii) of this paragraph except that X was a less developed country corporation for 1971. Assume further that Brown satisfies the requirements of paragraph (a) of §1.1248–5. Brown's ratable share in respect of the stock for 1971 is zero.

(5) *Qualified shareholder of foreign investment company*. In respect of a share (or block) of stock in a foreign corporation which was a foreign investment company described in section 1246 (b)(1), if the election under section 1247(a) to distribute income currently was in effect for a taxable year of the company, and if the person who sold or exchanged the stock (or another person who actually owned the stock during such taxable year and whose holding of the stock is attributed by reason of the application of section 1223, taking into account §1.1248–8, to the person who sold or exchanged the stock) was a qualified shareholder (as defined in section 1247(c)) for his taxable year in which or with which such taxable year of the company ends, then the ratable share in respect of the share (or block) for such taxable year of the company shall be zero. See section 1248(d)(5). In case gain is recognized under section 1246 in respect of a share (or block), see section 1248(f)(3)(B).

(6) *Adjustment for certain distributions*. If (i) the person who sold or exchanged the share or block (or another person who actually owned the share or block and whose holding of the share or block is attributed by reason of the application of section 1223 to such person, taking into account §1.1248–8) received a distribution during a taxable year of the corporation, and (ii) such distribution was not included in the gross income of such person (or such other person) by reason of the application of section 959(a)(1) to amounts which were included under section 951(a)(1) in the gross income of a United States shareholder whose holding of the share or block is not attributed by reason of the application of section 1223 to such person, taking into account §1.1248–8 (or such other person), then the amount of such distribution shall be added to such person's tentative ratable share for such taxable year. Thus, for example, such tentative ratable share may be increased, or a deficit reduced, by the amount of such distribution.

(f) *Earnings and profits of subsidiaries of foreign corporations*—(1) *Application of paragraph*. (i) In respect of a person who sells or exchanges stock in a foreign corporation (referred to as a *first tier* corporation), the provisions of this paragraph shall apply if the following 3 conditions exist:

(*a*) The conditions of paragraph (a)(2) of §1.1248–1 are satisfied by the person in respect of such stock;

(*b*) By reason of his ownership of such stock, on the date of such sale or exchange such person owned, within the meaning of section 958(a)(2), stock in another foreign corporation (referred to as a *lower tier* corporation); and

(*c*) The conditions of paragraph (a)(2) of §1.1248–1 would be satisfied by such person in respect of such stock in the lower tier corporation if such person were deemed to have sold or exchanged such stock in the lower tier corporation on the date he actually sold or exchanged such stock in the first tier corporation.

(ii) If the provisions of this paragraph apply, (*a*) the person's tentative ratable share (or shares) of the earnings and profits accumulated by the lower tier corporation attributable to a taxable year of the first tier corporation shall be computed under subparagraph (2) or (4) of this paragraph, whichever is applicable, and (*b*) such person's ratable share (or shares) for the lower tier corporation attributable to a taxable year of the first tier corporation shall be computed under subparagraph (5) of this paragraph. For the manner of taking into account the ratable share for a lower tier corporation, see paragraph (a)(3) of this section.

(iii) The application of this subparagraph may be illustrated by the following example:

Example: On each day of 1964 and 1965 corporations X and Y are controlled foreign corporations, and each has outstanding 100 shares of one class of stock. On January 15, 1965, T, a United States person, owns one share of stock in X and X directly owns 20 shares of stock in Y. Thus, T owns, within the meaning of section 958(a)(2), stock in Y.

On that date, T sells his share in X and satisfies the conditions of paragraph (a)(2) of § 1.1248–1 in respect of his stock in X. Assuming that the conditions of paragraph (a)(2) of § 1.1248–1 would be satisfied by T in respect of the stock he indirectly owns in Y if, on January 15, 1965, he were deemed to have sold such stock in Y, the provisions of this paragraph apply.

(2) *Tentative ratable share (of lower tier corporation attributable to a taxable year of first tier corporation) not less than zero*. If the provisions of this paragraph apply to a sale or exchange by a United States person of a share (or block) of stock in a first tier corporation, and if the amount of earnings and profits accumulated (computed under paragraph (b) of this section) for a taxable year (beginning after December 31, 1962) of the lower tier corporation is not less than zero, then in respect of the share (or block) such person's tentative ratable share of the earnings and profits accumulated for such taxable year of the lower tier corporation attributable to any taxable year (beginning after December 31, 1962) of such first tier corporation shall be an amount equal to:

(i)(*a*) Such amount of earnings and profits accumulated for such taxable year of the lower tier corporation (if the computation is made in respect of a block in the first tier corporation, multiplied by the number of shares in the block), divided by (*b*) the number of shares in the first tier corporation outstanding, or deemed under paragraph (c)(2) of this section to be outstanding, on each day of such taxable year of the first tier corporation, multiplied by

(ii) The percentage that (*a*) the number of days during the period or periods in such taxable year of the first tier corporation on which such person held (or was considered to have held by reason of the application of section 1223, taking into account § 1.1248–8) the share (or block) in the first tier corporation while the first tier corporation owned (within the meaning of section 958(a)) stock of such lower tier corporation at times while such lower tier corporation was a controlled foreign corporation, bears to (*b*) the total number of days in such taxable year of the first tier corporation, multiplied by

(iii) The percentage that (*a*) the average number of shares in the lower tier corporation which were owned within the meaning of section 958(a) by the first tier corporation during such period or periods (referred to in subdivision (ii)(*a*) of this subparagraph), bears to (*b*) the total number of such shares outstanding, or deemed under the principles of paragraph (c)(2) of this section to be outstanding, during such period or periods, multiplied by

(iv) The percentage that (*a*) the number of days in such taxable year of the lower tier corporation which fall within the taxable year of the first tier corporation, bears to (*b*) the total number of days in such taxable year of the lower tier corporation.

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

Example 1. In a year subsequent to 1969, Brown, a United States person, sells 5 of his shares of stock in X Corporation in a transaction as to which the provisions of this paragraph apply. Brown had purchased the 5 shares prior to 1969. On each day of 1969 X Corporation actually had 100 shares of one class of stock outstanding. On each such day X Corporation directly owned all of the shares of stock in Y Corporation, and Y Corporation directly owned all of the shares of stock in Z Corporation. Z Corporation on each such day was a controlled foreign corporation. Both X and Z use the calendar year as the taxable year. Z's earnings and profits accumulated for 1969 (computed under paragraph (b) of this section) are $2,000. Brown's tentative ratable share of the earnings and profits accumulated by Z attributable to the 1969 calendar year of X is $20 per share, computed as follows:

(i) Z's earnings and profits for 1969 ($2,000), divided by the number of shares in X deemed outstanding each day of 1969 (100)	$20
Multiplied by:	
(ii) Since on each day of 1969 Brown (by reason of owning directly his shares in X) owned, within the meaning of section 958(a)(2), stock in Z while Z was a controlled foreign corporation, the percentage determined under subparagraph (2)(ii) of this paragraph equals	100%
Multiplied by:	
(iii) Since on each day of 1969 X owned 100 percent of the stock of Y while Y owned 100 percent of the stock in Z, the percentage determined under subparagraph (2)(iii) of this paragraph equals	100%
Multiplied by:	
(iv) Since X and Z each use the same taxable year, the percentage determined under subparagraph (2)(iv) of this paragraph equals	100%
Total	$20

Example 2. Assume the same facts as in example (1), except that Brown sold his stock in X on October 19, 1969. Brown's tentative ratable share of the earnings and profits accumulated by Z attributable to the 1969 calendar year of X is $16 per share, computed as follows:

(i) The amount determined in subdivision (i) of example (1)	$20
Multiplied by:	
(ii) The number of days in the period during 1969 Brown (by reason of owning directly his stock in X) owned, within the meaning of section 958(a)(2), his stock in Z while Z was a controlled foreign corporation (292), divided by the number of days in 1969 (365), equals	80%
Multiplied by:	
(iii) The percentage determined in subdivision. (iii) of example (1)	100%
Multiplied by:	
(iv) The percentage determined in subdivision. (iv) of example (1)	100%
Total	$16

Example 3. Assume the same facts as in examples (1) and (2), except that on each day during 1969 Y owned (within the meaning of section 958(a)(2)) 81 of the 100 shares of Z's outstanding stock. Brown's tentative ratable share of the earnings and profits accumulated by Z attributable to the 1969 calendar year of X is $12.96 per share, computed as follows:

(i) The amount determined in subdivision (i) of example (1)	$20
Multiplied by:	
(ii) The percentage determined in subdivision (ii) of example (2)	80%
Multiplied by:	
(iii) The average number of shares in Z which were owned (within the meaning of section 958(a)) by X during the applicable period (81), divided by the total number of shares in Z during such period (100)	81%
Multiplied by:	
(iv) The percentage determined in subdivision (iv) of example (1)	100%
Total	$12.96

The result would be the same if X owned (within the meaning of section 958(a)(2)) 81 percent of the stock in Y while Y so owned 100 percent of the stock in X, or if X so owned 90 percent of the stock in Y while Y so owned 90 percent of the stock in Z.

Example 4. Assume the same facts as in example (3), except that Z Corporation uses a fiscal year ending June 30 as its taxable year. Assume further that Z's earnings and profits accumulated for its fiscal year ending June 30, 1969, and for its fiscal year ending June 30, 1970, are $3,000 and $2,000, respectively. Brown's tentative ratable share of the earnings and profits accumulated by Z attributable to the 1969 calendar year of X is $16.17 per share, computed as follows:

	In respect of Z's taxable year ending	
	June 30, 1969	June 30, 1970
(i) Z's earnings and profits, divided by the number of shares in X deemed outstanding on each day of 1969:		
$3,000/100	$30	
$2,000/100		$20
Multiplied by:		
(ii) The percentage determined in subdivision (ii) of example (2)	80%	80%
Multiplied by:		
(iii) The percentage determined in subdivision (iii) of example (3)	81%	81%
Multiplied by:		
(iv) Number of days in Z's taxable year which fall within 1969, divided by total number of days in Z's taxable year:		
181/365	49.6%	
184/365		50.4%
Totals	$9.64	$6.53
(v) Sum of tentative ratable shares of Z attributable to X's 1969 calendar year:		
For Z's taxable year ending		
June 30, 1969		$9.64
June 30, 1970		$6.53
Sum		$16.17

(4) *Deficit in tentative ratable share of lower tier corporation attributable to a taxable year of first tier corporation.* (i) If there is a deficit in the earnings and profits accumulated for a taxable year of a lower tier corporation beginning after December 31, 1962 (computed under paragraph (b) of this section), the person's tentative ratable share for such taxable year of such lower tier corporation attributable to a taxable year of a first tier corporation shall not be computed under subparagraph (2) of this paragraph but shall be an amount equal to the sum of the partial tentative ratable shares computed under subdivisions (ii) and (iii) of this subparagraph.

(ii) The partial tentative ratable share under this subdivision is computed in 2 steps. First, compute (under paragraph (b) of this section without regard to the adjustments for distributions under subparagraph (3) thereof) the deficit (if any) in earnings and profits accumulated for such taxable year of such lower tier corporation. Second, compute the partial tentative ratable

share in the same manner as such tentative ratable share would be computed under subparagraph (2) of this paragraph if such deficit were the amount referred to in subparagraph (2)(i)(a) of this paragraph.

(iii) The partial tentative ratable share under this subdivision is computed in 2 steps. First, compute and treat as a deficit the portion of the adjustment for distributions under paragraph (b)(3) of this section for such taxable year which is attributable under paragraph (d)(4) of this section to distributions of earnings and profits accumulated during prior taxable years of the lower tier corporation beginning after December 31, 1962, during the period or periods such lower tier corporation was a controlled foreign corporation and the percentage of the stock of such lower tier corporation (which the person owns within the meaning of section 958(a)(2)) was owned within the meaning of section 958(a) by a United States shareholder (as defined in section 951(b) and the regulations thereunder). Second, compute the partial tentative ratable share in the same manner as such tentative ratable share would be computed under subparagraph (2) of this paragraph if (a) such deficit were the amount referred to in subparagraph (2)(i)(a) of this paragraph, and (b) such lower tier corporation were a controlled foreign corporation on each day of such taxable year.

(5) *Ratable share of lower tier corporation attributable to a first tier corporation.* (i) If the provisions of this paragraph apply in respect of a share of stock in a first tier corporation, a person's ratable share of the earnings and profits accumulated by the lower tier corporation attributable to a taxable year of the first tier corporation shall be an amount equal to the tentative ratable share computed under subparagraph (2) or (4) of this paragraph, adjusted in the manner prescribed in this subparagraph.

(ii) If the first tier corporation and the lower tier corporation use the same taxable year, then in respect of a share (or block) of stock in the first tier corporation the person's tentative ratable share of the accumulated earnings and profits of the lower tier corporation attributable to the taxable year of the first tier corporation (computed under subparagraph (2) of this paragraph) shall be reduced (but not below zero) by the excess of (*a*) the amount, if any, included (in respect of such lower tier corporation for its taxable year) under section 951 in the gross income of such person or (during the period such stock was considered to be held by such person by reason of the application of section 1223, taking into account § 1.1248–8) in the gross income of any other person who held such stock, over (b) the portion of such amount which, in any taxable year of such person or such other person, resulted in an exclusion from the gross income of such person or such other person of an amount under section 959(a)(1). For an illustration of the principles in the preceding sentence, see the example in paragraph (e)(2)(ii) of this section.

(iii) If the first tier corporation and the lower tier corporation do not use the same taxable year, and if there would be an excess computed under subdivision (ii) of this subparagraph in respect of a taxable year of the lower tier corporation (were the taxable years of such corporations the same), then such person's tentative ratable share of the accumulated earnings and profits for a taxable year of the lower tier corporation attributable to such taxable year of the first tier corporation shall be reduced (but not below zero) by an amount which bears the same ratio to (*a*) such excess, as (*b*) the number of days in the taxable year of the lower tier corporation which fall within the taxable year of the first tier corporation, bears to (*c*) the total number of days in the taxable year of the first tier corporation.

(iv) If the first tier corporation and the lower tier corporation use the same taxable year, then in respect of a share (or block) of stock in the first tier corporation the person's tentative ratable share of the accumulated earnings and profits of the lower tier corporation attributable to the taxable year of the first tier corporation (computed under subparagraph (2) of this paragraph) shall be reduced (but not below zero) by the amount, if any, included (in respect of such corporation for such taxable year) under section 551, by reason of the application of section 555(b), in the

gross income of such person or (during the period such share (or block) was considered to be held by such person by reason of the application of section 1223, taking into account §1.1248–8) in the gross income of any other person who held such share (or block).

(v) If the first tier corporation and the lower tier corporation do not use the same taxable year, and if there would be a reduction in the person's tentative ratable share of the accumulated earnings and profits of the lower tier corporation attributable to the taxable year of the first tier corporation by an amount computed under subdivision (iv) of this subparagraph in respect of a taxable year of the lower tier corporation (were the taxable years of such corporations the same), then such person's tentative ratable share of the accumulated earnings and profits for a taxable year of the lower tier corporation attributable to such taxable year of the first tier corporation shall be reduced by an amount which bears the same ratio to (*a*) such amount, as (*b*) the number of days in the taxable year of the lower tier corporation which fall within the taxable year of the first tier corporation, bears to (*c*) the total number of days in the taxable year of the first tier corporation.

(vi) If the lower tier corporation was a less developed country corporation as defined in section 902(d) for a taxable year of the corporation, see paragraph (g) of this section.

(g) *Lower tier corporation a less developed country corporation*—(1) *General.* If the lower tier corporation was a less developed country corporation as defined in section 902(d) for a taxable year of such corporation, and if the person who sold or exchanged a share (or block) of stock in the first tier corporation satisfies on the date of such sale or exchange:

(i) The requirements of paragraph (a)(1) of §1.1248–5 with respect to such stock, and

(ii) The requirements of paragraph (d)(1) of §1.1248–5 with respect to any stock of the lower tier corporation which such person, by reason of his direct ownership of such stock in the first tier corporation, owned within the meaning of section 958(a)(2),

Then such person's ratable share (or a deficit in such ratable share) for such taxable year of the lower tier corporation attributable to a taxable year of the first tier corporation (determined without regard to this paragraph) shall be reduced by an amount computed by multiplying such ratable share (so determined without regard to this paragraph) by the percentage computed under either subparagraph (2) or (4) of this paragraph, whichever is applicable.

(2) *Percentage for second tier corporation.* For purposes of subparagraph (1) of this paragraph, if stock of a lower tier corporation (hereinafter referred to as a *second tier* corporation) is owned directly by the first tier corporation on the date of the sale or exchange referred to in such subparagraph (1), the percentage under this subparagraph shall be computed by dividing (i) the number of shares of stock of the second tier corporation which the first tier corporation has owned directly for an uninterrupted 10-year period ending on such date, by (ii) the total number of shares of the stock of such second tier corporation owned directly by such first tier corporation on such date.

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

Example 1. On January 1, 1966, Smith, a United States person, recognizes gain upon the sale of one share of the only class of stock of F Corporation, which he has owned continuously since 1955. He includes a portion of the gain in his gross income as a dividend under section 1248(a). On January 1, 1966, F owns directly 60 shares of the 100 outstanding shares of the only class of stock of G Corporation, which F acquired in 1955 and owned continuously until such sale. F uses a taxable year ending June 30, and G uses the calendar year as the taxable year. For 1964, G was a less developed country corporation, and on each day of 1964 G was a controlled foreign corporation. Smith's ratable share for G's taxable year ending December 31, 1964, attributable to F's taxable year ending June 30, 1965 (determined without regard to this paragraph) is $6.00. Since the percentage computed under subparagraph (2) of this paragraph is 100 percent (60 shares divided by 60 shares), Smith's ratable share for G's taxable year ending December 31, 1964, attributable to F's taxable year ending June 30, 1965 (after the application of subparagraph (2) of this paragraph) is zero (that is, $6.00 reduced by 100 percent of $6.00).

Example 2. Assume the same facts as in example (1) except that of the 60 shares of G Corporation which F Corporation owned on January 1, 1966, 20 shares were acquired in 1961. The percentage computed under subparagraph (2) of this paragraph is 66⅔ percent (40 shares divided by 60 shares). Accordingly, Smith's ratable share for G's taxable year ending December 31, 1964, attributable to F's taxable year ending June 30, 1965 (after the application of subparagraph (2) or this paragraph) is $2.00 (that is, $6.00 reduced by 66⅔ percent of $6.00).

(4) *Percentage for lower tier corporations other than second tier corporation.* For purposes of subparagraph (1) of this paragraph, if stock of a lower tier corporation (other than a second tier corporation) is owned within the meaning of section 958(a)(2) by the first tier corporation on the date of the sale or exchange referred to in such subparagraph (1), the percentage under this subparagraph shall be computed in the following manner:

(i) First, determine the percentage for the second tier corporation in accordance with subparagraph (2) of this paragraph.

(ii) Second, determine a partial percentage for each other lower tier corporation in the same manner as the percentage for the second tier corporation is determined. Thus, for example, the partial percentage for a third tier corporation is determined by dividing (*a*) the number of shares of stock of the third tier corporation which the second tier corporation has owned directly for an uninterrupted 10-year period ending on the date of the sale or exchange referred to in subparagraph (1) of this paragraph, by (*b*) the total number of shares of stock of such third tier corporation owned directly by such second tier corporation on such date.

(iii) Third, the percentage for a third tier corporation is the percentage for the second tier corporation multiplied by the partial percentage for the third tier corporation. The percentage for a fourth tier corporation is the percentage for the third tier corporation (as determined in the preceding sentence) multiplied by the partial percentage for the fourth tier corporation. In a similar manner, the percentage for any other lower tier corporation may be determined.

(5) *Example.* The application of subparagraph (4) of this paragraph may be illustrated by the following example:

Example: On January 1, 1967, Brown, a United States person recognizes gain upon the sale of one share of the only class of stock of W Corporation, which he has owned continuously since 1955. He includes a portion of the gain in his gross income as a dividend under section 1248(a). W is the first tier corporation of a chain of foreign corporations W, X, Y, and Z. W and Z each use the calendar year as the taxable year. For 1964, Z was a less developed country corporation and on each day of 1964 Z was a controlled foreign corporation. Additional facts are set forth in the table below:

Corporation—(1)	Shares directly owned by preceding tier—		Column (2) divided by column (3) (percent)—(4)
	For uninterrupted 10-year period ending Jan. 1, 1967—(2)	On Jan. 1, 1967—(3)	
X	40	60	66⅔
Y	30	40	75
Z	20	30	66⅔

For 1964, the percentage referred to in subparagraph (4) of this paragraph for Z is 33⅓ percent (66⅔% × 75% × 66⅔%).

(6) *Special rule.* For purposes of applying the provisions of this paragraph, a lower tier corporation may be treated as a second tier corporation with respect to any of its stock which is owned directly by a first tier corporation whereas such lower tier corporation may be treated as a lower tier corporation other than a second tier corporation with respect to other stock in such lower tier corporation which is owned (within the meaning of section 958(a)(2)) by such first tier corporation. Thus, for example, if corporations X, Y, and Z are foreign corporations, X is a first tier corporation owning directly 100 percent of the stock of Y and 40 percent of the stock of Z, and in addition Y owns directly 60 percent of the stock of Z, then the 40 percent of the Z stock (which X owns directly) is considered to be stock in a second tier corporation and the 60 percent of the Z stock (which Y owns directly and which X is considered to own within the meaning

of section 958(a)(2)) is considered to be stock in a third tier corporation.

[T.D. 6779, 29 FR 18133, Dec. 22, 1964, as amended by T.D. 7293, 38 FR 32803, Nov. 28, 1973; T.D. 7545, 43 FR 19652, May 8, 1978; T.D. 9345, 72 FR 41445, July 30, 2007; T.D. 9614, 78 FR 17041, Mar. 19, 2013]

§ 1.1248–4 Limitation on tax applicable to individuals.

(a) *General rule*—(1) *Limitation on tax*. Under section 1248(b), if during a taxable year an individual sells or exchanges stock in a foreign corporation, then in respect of the stock the increase in the individual's income tax liability for such taxable year which is attributable (under paragraph (b) of this section) to the amount included in his gross income as a dividend under section 1248(a) shall not be greater than an amount equal to the sum of:

(i) The excess, computed under paragraph (c) of this section in respect of the stock of the United States taxes which would have been paid by the corporation over the taxes (including United States taxes) actually paid by the corporation, plus.

(ii) An amount equal to the increase in the individual's income tax liability which would be attributable to the inclusion in his gross income for such taxable year, as long-term capital gain, of an amount equal to the excess of (*a*) the amount included in the individual's gross income as a dividend under section 1248(a) in respect of such stock, over (*b*) the excess referred to in subdivision (i) of this subparagraph.

(2) *Share or block*. In general, the limitation on tax attributable (under paragraph (b) of this section) to the amount included in an individual's gross income as a dividend under section 1248(a) shall be determined separately for each share of stock sold or exchanged. However, such determination may be made in respect of a block of stock if earnings and profits attributable to the block are computed under § 1.1248–2 or 1.1248–3. See paragraph (b) of § 1.1248–2 and paragraph (a)(5) of § 1.1248–3.

(3) *Application of limitation*. The provisions of subparagraph (1) of this paragraph shall not apply unless the individual establishes:

(i) In the manner prescribed in § 1.1248–7, the amount of the earnings and profits of the corporation attributable under paragraph (a)(1) of § 1.1248–2 or under paragraph (a)(1) of § 1.1248–3, whichever is applicable, to the stock, and

(ii) The amount equal to the sum described in subparagraph (1) of this paragraph, computed in accordance with the provisions of this section.

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

Example: On December 31, 1966, Smith, a United States person, sells a share of stock of X Corporation which he has owned continuously since December 31, 1965, and includes $100 of the gain on the sale in his gross income as a dividend under section 1248(a). Both X and Smith use the calendar year as the taxable year. The increase in Smith's income tax liability for 1966 which is attributable (under paragraph (b) of this section) to the inclusion of the $100 in his gross income as a dividend is $70. X was a controlled foreign corporation on each day of 1966. The excess computed under paragraph (c) of this section in respect of the share, of the United States taxes which X would have paid over the taxes (including United States taxes) actually paid by X is $49. Under section 1248(b), the limitation on the tax attributable to the $100 included by Smith in his gross income as a dividend under section 1248(a) is $61.75, computed as follows:

(i) Excess, computed under paragraph (c) of this section, of United States taxes which X Corporation would have paid in 1966 over the taxes actually paid by X in 1966		$49.00
(ii) The amount determined under subparagraph (1)(ii) of this paragraph:		
The amount Smith included in his gross income as a dividend under section 1248(a)	$100.00	
Less the excess referred to in subdivision (i) of this example	49.00	
Difference	51.00	
Increase in Smith's tax liability attributable to including $51 in his gross income as long-term capital gain (25 percent of $51)		12.75
(iii) Limitation on tax		61.75

(b) *Tax attributable to amount treated as dividend*—(1) *General*. For purposes of paragraph (a)(1) of this section, in respect of a share (or block) of stock in a foreign corporation sold or exchanged by an individual during a taxable year,

the tax attributable to the amount included in his gross income as a dividend under section 1248(a) shall be the amount which bears the same ratio to (i) the excess of (*a*) his income tax liability for the taxable year determined without regard to section 1248(b) over (*b*) such tax liability determined as if the portion of the total gain recognized during the taxable year which is treated as a dividend under section 1248(a) had not been recognized, as (ii) the amount included as a dividend under section 1248(a) in respect of the share (or block), bears to (iii) the total amount included as a dividend under section 1248(a) in the individual's gross income for such taxable year.

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

Example 1. (i) During 1963, Brown, an unmarried United States person, sells a block of stock in a controlled foreign corporation. On the sale, he recognizes $22,000 gain, of which $18,000 is treated as a dividend under section 1248(a) and $4,000 as long-term capital gain. Brown computes his income tax liability for his taxable year ending December 31, 1963, under section 1201 (relating to alternative tax) in accordance with the additional facts assumed in the following table:

	Computation of income tax liability without regard to section 1248(b)	Computation of income tax liability as if the gain treated as a divided under section 1248(a) had not been recognized
Income from salary	$300,000	$300,000
Long-term capital gain resulting from sale of stock, less deduction for capital gains under section 1202 ($4,000 less $2,000)	2,000	2,000
Amount treated as a dividend under section 1248(a)	18,000	0
Adjusted gross income	320,000	302,000
Charitable contribution of $100,000 to church (limited under section 170(b) to 30 percent of adjusted gross income)	(96,000)	(90,600)
Other itemized deductions and personal exemption	(7,700)	(7,700)
Taxable income	216,300	203,700
Less 50 percent of $4,000	2,000	2,000
Amount subject to partial tax under section 1201(b)(1)	214,300	201,700
Partial tax	169,833	158,367
25 percent of $4,000	1,000	1,000
Tax liability	170,833	159,367

(ii) The tax attributable to the $18,000 treated as a dividend under section 1248(a) is $11,466 ($170,833 minus $159,367).

Example 2. Assume the same facts as in example (1) except that the $18,000 treated as a dividend under section 1248(a) is attributable to the sale of a block of stock in X Corporation and a block of stock in Y Corporation. Assume further that $10,000 of the gain on the block of X stock was treated as a dividend and that $8,000 of the gain on the block of Y stock was treated as a dividend. Thus, the tax attributable to the amount treated as a dividend in respect of the block of X stock is $6,370 ($10,000/$18,000 of $11,466) and the amount in respect of the block of Y stock is $5,096 ($8,000/$18,000 of $11,466). The result would be the same if both blocks of stock were blocks of stock in the same corporation.

(c) *Excess (of United States taxes which would have been paid over taxes actually paid) attributable to a share (or block)*—(1) *General*. For purposes of paragraph (a)(1)(i) of this section:

(i) The term *taxes* means income, war profits, or excess profits taxes, and

(ii) The excess (and the portion of such excess attributable to an individual's share or block of stock in a foreign corporation) of the United States taxes which would have been paid by the corporation over the taxes (including United States taxes) actually paid by the corporation, for the period or periods the stock was held (or was considered to be held by reason of the application of section 1223) by the individual in taxable years of the corporation beginning after December 31, 1962, while the corporation was a controlled foreign corporation, shall be computed in accordance with the steps set forth in subparagraphs (2), (3), and (4) of this paragraph.

(2) *Step 1.* For each taxable year of the corporation beginning after December 31, 1962, in respect of the individual's share (or block) of such stock (i) the taxable income of the corporation shall be computed in the manner prescribed in paragraph (d) of this section, and (ii) the excess (and the portion of such excess attributable to the stock of the United States taxes which would have been paid by the corporation on such taxable income over the taxes (including United States taxes) actually paid by the corporation shall be computed in the manner prescribed in paragraph (e) of this section.

(3) *Step 2.* If during such taxable year the corporation is a first tier corporation to which paragraph (f) of this section applies, (i) the excess (and the portion of such excess attributable to the individual's share, or block, of stock in the first tier corporation) of the United States taxes which would have been paid by any lower tier corporation over the taxes (including United States taxes) actually paid by such lower tier corporation shall be computed under paragraph (f) of this section, and (ii) such portion shall be added to the portion of the excess attributable to the individual's share (or block) of such stock as determined in step 1 for such taxable year.

(4) *Step 3.* The excess, in respect of the individual's share (or block), of the United States taxes which would have been paid by the corporation over the taxes actually paid by the corporation shall be the sum of the portions computed for each such taxable year in the manner prescribed in steps 1 and 2.

(d) *Taxable income.* For purposes of paragraph (c)(2)(i) of this section, taxable income shall be computed in respect of an individual's share (or block) in accordance with the following rules:

(1) *Application of principles of § 1.952–2.* Except as otherwise provided in this paragraph, the principles of paragraphs (a)(1), (b)(1), and (c) of § 1.952–2 (other than subparagraphs (2)(iii)(*b*), (2)(v), (5)(i), and (6) of such paragraph (c)) shall apply.

(2) *Effect of elections.* In respect of a taxable year of a foreign corporation, no effect shall be given to an election or an adoption of accounting method unless for such taxable year effect is given to such election or adoption of accounting method under paragraph (d)(1) of § 1.1248–2 or paragraph (b)(1) of § 1.1248–3, whichever is applicable.

(3) The deductions for certain dividends received provided in sections 243, 244, and 245 shall not be allowed.

(4) *Deduction for taxes.* In computing the amount of the deduction allowed under section 164, there shall be excluded income, war profits, or excess profits taxes paid or accrued which are imposed by the authority of any foreign country or possession of the United States.

(5) *Capital loss carryover.* In determining the amount of a net capital loss to be carried forward under section 1212 to the taxable year:

(i) No net capital loss shall be carried forward from a taxable year beginning before January 1, 1963.

(ii) The portion of a net capital loss or a capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for a taxable year beginning after December 31, 1962, which shall be taken into account shall be the amount of such loss or gain (as the case may be), multiplied by the percentage which (*a*) the number of days in such taxable year during which the individual held (or was considered to have held by reason of the application of section 1223) the share (or block) of stock sold or exchanged while the corporation was a controlled foreign corporation, bears to (*b*) the total number of days in such taxable year.

(iii) The application of this subparagraph may be illustrated by the following examples:

Example 1. Corporation X is a foreign corporation which was created on January 1, 1963, and which uses the calendar year as its taxable year. X was a controlled foreign corporation on each day of the period March 15, 1963, through December 31, 1965, but was not a controlled foreign corporation on any day during the period January 1, 1963, through March 14, 1963. On December 31, 1965, Smith, a United States person, sells a share of X stock which he has owned continuously since January 1, 1963. A portion of the gain recognized on the sale is includible in Smith's gross income as a dividend under section 1248(a). X had a net capital loss (determined without regard to subchapter N, chapter 1 of the Code) of $200 for 1963. Since, however, X was a controlled foreign corporation for only 292 days in 1963, for purposes of determining

the net capital loss carryover to 1964 the portion of the net capital loss of $200 for 1963 which Smith takes into account under subdivision (ii) of this subparagraph is $160 (292/365 of $200), and, accordingly, the amount of the net capital loss carryover to 1964 is $160.

Example 2. Assume the same facts as in example (1), except that X was not a controlled foreign corporation on any day of the period May 26, 1964, through June 30, 1965. Assume further that X had a net capital gain (capital gain net income for taxable years beginning after December 31, 1976) (determined without regard to subchapter N, chapter 1, of the Code) of $160 for 1964. In computing X's taxable income for 1964 under this paragraph, Smith applies the net capital loss carryover of $160 from 1963 to reduce the net capital gain of $160 for 1964 to zero. Since, however, X was a controlled foreign corporation for only 146 days in 1964, for purposes of computing the portion of the 1963 capital loss of $160 which is a net capital loss carryover to 1965, the portion of the 1964 capital gain which Smith takes into account under subdivision (ii) of this subparagraph is $63.83 (146/366 of $160). Thus, the net capital loss carryover to 1965 is $96.17 ($160 minus $63.83).

(6) *Net operating loss deduction.* (i) The individual shall reduce the taxable income (computed under subparagraphs (1) through (5) of this paragraph) of the corporation for the taxable year by the amount of the net operating loss deduction of the corporation computed under section 172, as modified in the manner prescribed in this subparagraph.

(ii) The rules of subparagraphs (1) through (5) of this paragraph shall apply for purposes of determining the excess referred to in section 172(c) and the taxable income referred to in section 172(b)(2).

(iii) A net operating loss shall not be carried forward from, or carried back to, a taxable year beginning before January 1, 1963.

(iv) The portion of a net operating loss incurred, or of taxable income earned, in a taxable year beginning after December 31, 1962, which shall be taken into account under section 172(b)(2) shall be the amount of such loss or income (as the case may be), multiplied by the percentage which (*a*) the number of days in such taxable year during which the individual held (or was considered to have held by reason of the application of section 1223) the share (or block) of stock sold or exchanged while the corporation was a controlled foreign corporation, bears to (*b*) the total number of days in such taxable year.

(v) For illustrations of the principles of this subparagraph, see the examples relating to net capital loss carryovers in subparagraph (5)(iii) of this paragraph.

(7) *Adjustment for amount previously included in gross income of United States shareholders.* In respect of the individual's share (or block) of stock sold or exchanged, the taxable income of the corporation for the taxable year (determined without regard to this subparagraph and subparagraph (8) of this paragraph) shall be reduced (but not below zero) by an amount equal to the sum of the amounts included under section 951 in the gross income of United States shareholders (as defined in section 951(b)) of the corporation for the taxable year.

(8) *Adjustment for distributions.* In respect of the individual's share (or block) of stock sold or exchanged, the taxable income of the corporation for the taxable year (determined without regard to this subparagraph) shall be reduced (but not below zero) by the amount of the distributions (other than in redemption of stock under section 302(a) or 303) made by the corporation out of earnings and profits of such taxable year (within the meaning of section 316(a)(2)). For purposes of the preceding sentence, distributions shall be taken into account only to the extent not excluded from the gross income of the United States shareholders of the corporation under section 959.

(e) *Excess attributable to a share (or block) of stock*—(1) *Excess of United States taxes which would have been paid over taxes actually paid.* For purposes of paragraph (c)(2)(ii) of this section, in respect of a taxable year of a foreign corporation, the portion of the excess under this subparagraph which is attributable to an individual's share (or block) of such stock shall be an amount equal to:

(i) The excess (if any) of (*a*) the United States taxes which would have been paid by the corporation on its taxable income (computed under paragraph (d) of this section) for the taxable year had it been taxed as a domestic corporation under chapter 1 of the

Code (but without regard to subchapters F, G, H, L, M, N, S, and T thereof) for such taxable year, over (*b*) the income, war profits, or excess profits taxes actually paid by the corporation during such taxable year (including such taxes paid to the United States),

(ii) Multiplied by the percentage that (*a*) the number of days in such taxable year of the corporation during the period or periods the share (or block) was held (or was considered as held by reason of the application of section 1223) by the individual while the corporation was a controlled foreign corporation, bears to (*b*) the total number of days in such taxable year,

(iii) If the computation is made in respect of a block, multiplied by the number of shares in the block, and

(iv) Divided by the number of shares in the corporation outstanding, or deemed under paragraph (c)(2) of § 1.1248–3 to be outstanding, on each day of such taxable year.

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

Example: (i) Jones, a United States person, owns on each day of 1963 10 shares of the 100 shares of the only class of outstanding stock of X corporation. He sells one of such shares on December 31, 1963. X corporation is a controlled foreign corporation on each day of 1963 and Jones and X each use the calendar year as the taxable year. For 1963, the excess of the United States taxes which would have been paid by X had it been taxable as a domestic corporation over the taxes (including United States taxes) actually paid by X is $23,500, computed as follows:

Amount subject to partial tax under section 1201(a)(1), as computed by Jones:		
Taxable income		$300,000
Less excess of net long-term capital gain over net short-term capital loss		100,000
Amount subject to partial tax		200,000
Excess determined under subparagraph (1)(i) of this paragraph:		
30 percent × $25,000	$7,500	
52 percent × $175,000	91,000	
Partial tax		98,500
25 percent × $100,000		25,000
United States taxes X would have paid (alternative tax computed under section 1201(a))		123,500
Less income taxes X actually paid to:		
United States	$10,000	
Foreign countries	90,000	
Total		$100,000
Excess		23,500
Multiplied by:		
Percentage determined under subparagraph (1)(ii) of this paragraph:		
Since on each day of 1963, Jones held the share of X stock while X was a controlled foreign corporation, the percentage equals		100%
Total		$23,500

(ii) The portion of the excess determined in subdivision (i) of this example which is attributable to the share held by Jones is $235, that is, the amount of such excess ($23,500), divided by the number of shares of X deemed to be outstanding on each day of 1963 (100).

(3) *More than one class of stock*. If a foreign corporation for a taxable year has more than one class of stock outstanding, then before applying subparagraph (1) of this paragraph the excess (if any) which would be determined under subparagraph (1)(i) of this paragraph shall be allocated to each class of stock in accordance with the principles of paragraph (e) (2) and (3) of § 1.951–1, applied as if the corporation were a controlled foreign corporation on each day of such taxable year.

(f) *Subsidiaries of foreign corporations*—(1) *Excess for lower tier corporation attributable to taxable year of first tier corporation*. For purposes of paragraph (c)(3) of this section, if the provisions of paragraph (a)(3) of § 1.1248–2 or paragraph (f) of § 1.1248–3 apply in the case of the sale or exchange by an individual of a share (or block) of stock in a first tier corporation, then in respect of a taxable year of a lower tier corporation (beginning after December 31, 1962) which includes at least one day which falls within a taxable year of the first tier corporation (beginning after December 31, 1962), the portion of the excess under this subparagraph attributable to the share shall be an amount equal to:

(i) The excess (if any) of (*a*) the United States taxes which would have been paid by the lower tier corporation on its taxable income (computed under paragraph (g) of this section) for such taxable year of the lower tier corporation had it been taxed as a domestic corporatin under chapter 1 of the Code (but without regard to subchapters F, G, H, L, M, N, and T thereof) for such taxable year of the lower tier corporation, over (*b*) the income, war profits,

or excess profits taxes actually paid by the lower tier corporation during such taxable year (including such taxes paid to the United States),

(ii) Multiplied by each of the percentages described under paragraph (f)(2)(ii), (iii), and (iv) of § 1.1248–3 in respect of such taxable year of the first tier corporation,

(iii) If the computation is made in respect of a block of stock, multiplied by the number of shares in the block, and

(iv) Divided by the number of shares in the first tier corporation outstanding, or deemed under paragraph (c)(2) of § 1.1248–3 to be outstanding, on each day of such taxable year of the first tier corporation.

(2) *More than one class of stock.* If a foreign corporation for a taxable year has more than one class of stock outstanding, then before applying subparagraph (1) of this paragraph the principles of paragraph (e)(3) of this section shall apply.

(g) *Taxable income of lower tier corporations*—(1) *General.* For purposes of paragraph (f)(1)(i) of this section, in respect of the individual's share (or block) the taxable income of a lower tier corporation shall be computed in the manner provided in paragraph (d) of this section, except as provided in this paragraph.

(2) *Capital loss carryover.* For purposes of subparagraph (1) of this paragraph, the provisions of paragraph (d)(5)(ii) of this section shall not apply. In determining the amount of a net capital loss to be carried forward under section 1212 to the taxable year of a lower tier corporation, the portion of a net capital loss or a capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for a taxable year of the lower tier corporation beginning after December 31, 1962, which shall be taken into account shall be the amount of such loss or gain (as the case may be), multiplied by the percentage which (i) the number of days in such taxable year during the period or periods the individual held (or was considered to have held by reason of the application of section 1223) the share (or block) of stock in the first tier corporation sold or exchanged while the first tier corporation owned (within the meaning of section 958 (a)) stock in the lower tier corporation while the lower tier corporation was a controlled foreign corporation, bears to (ii) the total number of days in such taxable year.

(3) *Net operating loss deduction.* For purposes of subparagraph (1) of this paragraph, the provisions of paragraph (d)(6)(iv) of this section shall not apply. In determining the amount of the net operating loss deduction for a taxable year of a lower tier corporation, the portion of a net operating loss incurred, or of taxable income earned, in a taxable year of the lower tier corporation beginning after December 31, 1962, which shall be taken into account under section 172(b)(2) shall be the amount of such loss or income (as the case may be) multiplied by the percentage described in subparagraph (2) of this paragraph for such taxable year.

[T.D. 6779, 29 FR 18139, Dec. 22, 1964, as amended by T.D. 7545, 43 FR 19653, May 8, 1978; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1248–5 Stock ownership requirements for less developed country corporations.

(a) *General rule*—(1) *Requirements.* For purposes of paragraph (e)(4) of § 1.1248–3, a United States person shall be considered as satisfying the requirements of this paragraph with respect to a share (or block) of stock of a foreign corporation if on the date he sells or exchanges such share (or block):

(i) The 10-year stock ownership requirement of paragraph (b) of this section is met with respect to such share (or block), and

(ii) In the case of a United States person which is a domestic corporation, the requirement of paragraph (c) of this section, if applicable, is met.

(2) *Ownership of stock.* For purposes of this section:

(i) The rules for determining ownership of stock prescribed by section 958 (a) and (b) shall apply.

(ii) Stock owned by a United States person who is an individual, estate, or trust which was acquired by reason of the death of the predecessor in interest of such United States person shall be considered as owned by such United States persons during the period such stock was owned by such predecessor in interest, and during the period such

stock was owned by any other predecessor in interest if between such United States person and such other predecessor in interest there was no transfer other than by reason of the death of an individual.

(b) *10-year stock ownership requirement*—(1) *General.* A United States person meets the 10-year stock ownership requirement with respect to a share (or block) of stock in a foreign corporation which he sells or exchanges only if the share (or block) was owned (under the rules of paragraph (a)(2) of this section) by such person for a continuous period of at least 10 years ending on the date of the sale or exchange. See the first sentence of section 1248(d)(3). Thus, for example, if Jones, a United States person, sells a share of stock in a foreign corporation on January 1, 1965, the 10-year stock ownership requirement is met with respect to a share only if the share was owned (under the rules of paragraph (a)(2) of this section) by Jones continuously from January 1, 1955, to January 1, 1965. If a foreign corporation has not been in existence for at least 10 years on the date of the sale or exchange of the share, the 10-year stock ownership requirement cannot be met.

(2) *Special rule.* For purposes of this paragraph, a United States person shall be considered to have owned stock during the period he was considered to have held the stock by reason of the application of section 1223.

(c) *Disqualification of domestic corporation as a result of changes in ownership of its stock*—(1) *General.* (i) For purposes of paragraph (a)(1)(ii) of this section, the requirement of this paragraph must be met only if, on at least one day during the 10-year period ending on the date of the sale or exchange by a domestic corporation of a share of stock in a foreign corporation, one or more noncorporate United States shareholders (as defined in subdivision (iii) of this subparagraph) own more than 50 percent of the total combined voting power of all classes of stock entitled to vote of the domestic corporation.

(ii) The requirement of this paragraph is that if one or more persons are noncorporate United States shareholders on the first such day (referred to in subdivision (i) of this subparagraph), such person or persons continue after such first day, at all times during the remainder of such 10-year period, to own in the aggregate more than 50 percent of the total combined voting power of all classes of stock entitled to vote of the domestic corporation. For purposes of determining whether a domestic corporation meets the requirement of this paragraph, the stock owned by a United States person who is a noncorporate United States shareholder of a domestic corporation on such first day shall not be counted at any time after he ceases during such 10-year period to be a noncorporate United States shareholder of such corporation.

(iii) For purposes of this paragraph, the term *noncorporate United States shareholder* means, with respect to a domestic corporation, a United States person who is an individual, estate, or trust and who owns 10 percent or more of the total combined voting power of all classes of stock of such domestic corporation.

(iv) For purposes of this paragraph, the percentage of the total combined voting power of stock of a foreign corporation owned by a United States person shall be determined in accordance with the principles of section 951(b) and the regulations thereunder.

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

Example 1. During the entire period beginning December 31, 1954, and ending December 31, 1964, domestic corporation N owns all the stock of controlled foreign corporation X, a less developed country corporation. On December 31, 1964, N recognizes gain upon the sale of all its X stock. A, B, and C, who are unrelated individuals, were the only United States persons owning, or considered as owning, 10 percent or more of the total combined voting power of all classes of stock entitled to vote of N at any time during the 10-year period December 31, 1954, through December 31, 1964. The percentages of the total combined voting power in N, which A, B, and C owned during such 10-year period, are as follows:

Owner	Dec. 31, 1954–Apr. 1, 1957 (*Percent*)	Apr. 2, 1957–Oct. 1, 1959 (*Percent*)	Oct. 2, 1959–Dec. 31, 1964 (*Percent*)
A	20	20	20
B	9	30	30

Owner	Dec. 31, 1954–Apr. 1, 1957 (*Percent*)	Apr. 2, 1957–Oct. 1, 1959 (*Percent*)	Oct. 2, 1959–Dec. 31, 1964 (*Percent*)
C	30	15	9

Domestic corporation N does not meet the requirement of this paragraph with respect to the stock of controlled foreign corporation X for the following reasons:

(i) April 2, 1957, is the first day (during the 10-year period ending on December 31, 1964, the date N sells the X stock) on which noncorporate United States shareholders of N own more than 50 percent of the total combined voting power in N, and thus the requirement of this paragraph must be met. See subparagraph (1)(i) of this paragraph. Although A, B, and C did own, in the aggregate, more than 50 percent of such voting power before April 2, 1957, the voting power owned by B is not counted because B was not a noncorporate United States shareholder of N before such date.

(ii) Although C is a noncorporate United States shareholder on April 2, 1957, C ceases to own 10 percent or more of the total combined voting power in N on October 2, 1959. Thus, after October 1, 1959, the N stock which C owns is not counted for purposes of determining whether the more-than-50-percent stock ownership test is met. See subparagraph (1)(ii) of this paragraph. Accordingly, after October 1, 1959, the requirement of this paragraph is not met.

Example 2. Assume the same facts as in example (1), except that B's wife owns directly 5 percent of the total combined voting power in N from December 31, 1954, to December 31, 1964. On the basis of the assumed facts, N meets the requirement of this paragraph with respect to the stock of controlled foreign corporation X for the following reasons:

(i) December 31, 1954, is the first day (of the 10-year period ending on the date N sells the X stock) on which noncorporate United States shareholders of N own more than 50 percent of the total combined voting power in N. B is a noncorporate United States shareholder on such date because he owns, and is considered as owning, 14 percent of the total combined voting power in N (9 percent directly, and, under section 958(b), 5 percent constructively). Thus, on December 31, 1954, noncorporate United States shareholders A, B, and C own, in the aggregate, more than 50 percent of the total combined voting power in N.

(ii) A, B, and C, the noncorporate United States shareholders of N on December 31, 1954, own, and are considered as owning, more than 50 percent of the total voting power of N from December 31, 1954, to October 1, 1959. Since beginning on October 2, 1959, A owns 20 percent and B owns, and is considered as owning, 35 percent of the total combined voting power in N, A and B owns, and are considered as owning, more than 50 percent of the total combined voting power in N from October 2, 1959, to December 31, 1964. Therefore, the requirement of this paragraph is met.

(d) *Application of section to lower tier corporation*—(1) *General.* For purposes of paragraph (g)(1)(ii) of §1.1248–3, a United States person satisfies the requirements of this subparagraph in respect of stock of a lower tier corporation which such person, by reason of his direct ownership of the share (or block) of the first tier corporation sold or exchanged, owned within the meaning of section 958(a)(2) on the date he sold or exchanged such share (or block), if on such date:

(i) The 10-year stock ownership requirement of paragraph (b) of this section is met by such person with respect to any stock in the lower tier corporation which such person so owned, and

(ii) In the case of a United States person which is a domestic corporation, the requirement of paragraph (c) of this section, if applicable, is met.

(2) *Special rule.* For purposes of this paragraph, in applying paragraphs (b) and (c) of this section, the sale or exchange of a share (or block) of stock in a first tier corporation by a United States person shall be deemed to be the sale or exchange of any stock in a lower tier corporation which the person, by reason of his direct ownership of such share (or block) of the first tier corporation, owned within the meaning of section 958(a)(2) on the date he actually sold or exchanged such share (or block) in the first tier corporation.

[T.D. 6779, 29 FR 18142, Dec. 22, 1964]

§1.1248–6 Sale or exchange of stock in certain domestic corporations.

(a) *General rule.* If a United States person recognizes gain upon the sale or exchange of a share (or block) of stock of a domestic corporation which was formed or availed of principally for the holding, directly or indirectly, of stock of one or more foreign corporations, and if the conditions of paragraph (a)(2) of §1.1248–1 would be met by such person in respect of the share (or block) if the domestic corporation were a foreign corporation, then section 1248 shall apply in respect of such gain in accordance with the rules provided in

paragraph (b) of this section. See paragraph (d) of this section for a rule suspending the application of this section in certain circumstances.

(b) *Application.* (1) The gain referred to in paragraph (a) of this section shall be included in the gross income of the United States person as a dividend under section 1248(a) to the extent of the earnings and profits attributable under §1.1248–2 or §1.1248–3, whichever is applicable, to the share (or block), computed, however, in accordance with the following rules:

(i) The domestic corporation shall be treated as if it were a first tier foreign corporation;

(ii) If, after the application of subdivision (i) of this subparagraph, the provisions of paragraph (a)(3) of §1.1248–2 or paragraph (f) of §1.1248–3 (as the case may be) would apply in respect of a foreign corporation the stock of which is owned (within the meaning of section 958(a)) by the domestic corporation treated as the first tier corporation, such foreign corporation shall be considered a lower tier corporation;

(iii) Except to the extent provided in subdivision (iv) of this subparagraph, the earnings and profits of the domestic corporation treated as the first tier corporation accumulated for a taxable year, as computed under paragraph (d) of §1.1248–2 or paragraph (b) of §1.1248–3 (as the case may be), shall be considered to be zero; and

(iv) If, during a taxable year, a domestic corporation treated as the first tier corporation realizes gain upon the sale or exchange of stock in a foreign corporation, and solely by reason of the application of section 337 (relating to certain liquidations) the gain was not recognized, then the earnings and profits of such domestic corporation accumulated for the taxable year, as computed under paragraph (d) of §1.1248–2 or paragraph (b) of §1.1248–3 (as the case may be), shall be considered to be an amount equal to the portion of such gain realized during the taxable year which, if section 337 had not applied, would have been treated as a dividend under section 1248(a).

(2) If the person selling or exchanging the stock in the domestic corporation is an individual, the limitation on tax attributable to the amount included in his gross income as a dividend under subparagraph (1) of this paragraph shall be determined, in accordance with the principles of paragraph (f) of §1.1248–4, by treating the domestic corporation as a first tier corporation.

(3)(i) If the earnings and profits of the foreign corporation or corporations (or of the domestic corporation treated as a first tier corporation) to be taken into account under subparagraph (1) of this paragraph are not established in the manner provided in paragraph (a)(1) of §1.1248–7, all of the gain from the sale or exchange of the share (or block) of the domestic corporation shall be treated as a dividend.

(ii) To the extent that the person does not establish, in the manner provided in paragraph (c) of §1.1248–7, the foreign taxes paid by such foreign corporation or corporations to be taken into account for purposes of computing the limitation on tax attributable to a share, such foreign taxes shall not be taken into account for purposes of such computation.

(c) *Corporation formed or availed of principally for holding stock of foreign corporations.* Whether or not a domestic corporation is formed or availed of principally for the holding, directly or indirectly, of stock of one or more foreign corporations shall be determined on the basis of all the facts and circumstances of each particular case.

(d) *Temporary suspension of section 1248(e).* Section 1248(e) and the rules of this section do not apply to a sale, exchange, or other disposition of the stock of a domestic corporation during a period when capital gains are taxed at a rate that equals or exceeds the rate at which ordinary income is taxed.

(e) *Effective/applicability date.* Paragraph (d) of this section applies to a sale, exchange, or other disposition of the stock of a domestic corporation on or after September 21, 1987.

[T.D. 6779, 29 FR 18143, Dec. 22, 1964, as amended by T.D. 9614, 78 FR 17042, Mar. 19, 2013]

§ 1.1248–7 Taxpayer to establish earnings and profits and foreign taxes.

(a) *In general.* (1) If a taxpayer sells or exchanges stock in a foreign corporation which was a controlled foreign corporation and the Commissioner determines that the taxpayer has not established the amount of the earnings and profits of the corporation attributable to the stock under § 1.1248–2 or § 1.1248–3, whichever is applicable, all the gain from such sale or exchange shall be treated as a dividend under section 1248(a). See section 1248(h). A taxpayer shall be considered to have established such amount if:

(i) He attaches to his income tax return, filed on or before the last day prescribed by law (including extensions thereof) for his taxable year in which he sold or exchanged the stock, the schedule prescribed by paragraph (b) of this section or, if such last day is before April 1, 1965, he files such schedule before such date with the district director with whom such return was filed, and

(ii) He establishes in the manner prescribed by paragraph (d) of this section the correctness of each amount shown on such schedule.

(2) Notwithstanding an omission of information from, or an error with respect to an amount shown on, the schedule referred to in subparagraph (1)(i) of this paragraph, a taxpayer shall be considered to have complied with such subparagraph (1)(i) if:

(i) He establishes that such omission or error was inadvertent, or due to reasonable cause and not due to willful neglect, and that he has substantially complied with the requirements of this section, and

(ii) The taxpayer corrects such omission or error at the time when he complies with paragraph (d) of this section.

(3) For the requirement to establish the amount of foreign taxes to be taken into account for purposes of section 1248(b), see paragraph (c) of this section.

(b) *Schedule attached to return.* (1) The taxpayer shall attach to his income tax return for his taxable year in which he sold or exchanged the stock, a schedule showing his name, address, and identifying number. Except to the extent provided in paragraph (e) of this section, the schedule shall also show the amount of the earnings and profits attributable under paragraph (a) of § 1.1248–2 or paragraph (a) of § 1.1248–3 (as the case may be) to the stock, and, in order to support the computation of such amount, any additional information required by subparagraphs (2), (3), (4), and (5) of this paragraph.

(2) The schedule shall also show for the first tier corporation, and for each lower tier corporation as to which information is required under subparagraph (4) of this paragraph, (i) the name of the corporation, (ii) the country under whose laws the corporation is created or organized, and (iii) the last day of the taxable year which the corporation regularly uses in computing its income.

(3) If the amount of earnings and profits attributable to a block of stock sold or exchanged are computed under § 1.1248–2, the schedule shall also show:

(i) For each taxable year of the corporation, beginning after December 31, 1962, during the period the taxpayer held (or was considered to have held by reason of the application of section 1223, taking into account § 1.1248–8) the block, (a) the earnings and profits accumulated for each such taxable year computed under paragraph (d) of § 1.1248–2, and (b) the sum thereof computed under paragraph (e) (1)(i) and (2) of § 1.1248–2,

(ii) The number of shares in the block and the total number of shares of the corporation outstanding during such period,

(iii) If during the period the person held (or is considered to have held by reason of the application of section 1223, taking into account § 1.1248–8) the block any amount was included under section 951 in the gross income of such person (or another person) in respect of the block, the computation of the excess referred to in paragraph (e)(3)(ii) of § 1.1248–2, and

(iv) If the amount of earnings and profits of a lower tier corporation attributable to the block are computed under paragraph (a)(3) of § 1.1248–2, (a) the number of shares in the lower tier corporation which the taxpayer owns within the meaning of section 958(a)(2)(b) the total number of shares

of such lower tier corporation outstanding during such period, and (c) in respect of such lower tier corporation, the information prescribed in subdivisions (i) and (iii) of this subparagraph.

(4) If the amount of earnings and profits attributable to a share (or block) sold or exchanged are computed under § 1.1248–3, the schedule shall also show for each taxable year of the corporation beginning after December 31, 1962, any day of which falls in a period or periods the taxpayer held (or was considered to have held by reason of the application of section 1223, taking into account § 1.1248–8) the stock while the corporation was a controlled foreign corporation:

(i) The number of days in such period or periods, but only if such number is less than the total number of days in such taxable year,

(ii) The earnings and profits accumulated for the taxable year computed under paragraph (b) of § 1.1248–3,

(iii) The number of shares in the corporation outstanding, or deemed under paragraph (c)(2) of § 1.1248–3 to be outstanding, on each day of the taxable year,

(iv) The taxpayer's tentative ratable share computed under paragraph (c) or (d) (as the case may be) of § 1.1248–3,

(v) The amount of, and a short description of each adjustment to, the tentative ratable share under paragraph (e) of § 1.1248–3, and

(vi) The amount of the ratable share referred to in paragraph (e)(1) of § 1.1248–3.

(5) In respect of a taxable year referred to in subparagraph (4) of this paragraph of a first tier corporation, if the taxpayer is required to compute under paragraph (f)(5) of § 1.1248–3 his ratable share of the earnings and profits for a taxable year of the lower tier corporation attributable to such taxable year of such first tier corporation, then for such taxable year of the lower tier corporation the schedule shall show:

(i) The earnings and profits accumulated for the taxable year of the lower tier corporation, computed under paragraph (b) of § 1.1248–3,

(ii) Each percentage described in paragraph (f)(2) (ii), (iii), and (iv) of § 1.1248–3,

(iii) The amount of the taxpayer's tentative ratable share computed under paragraph (f) (2) or (4) (as the case may be) of § 1.1248–3,

(iv) The amount of, and a short description of each adjustment to, the tentative ratable share under paragraph (f)(5) of § 1.1248–3, and

(v) The amount of the ratable share referred to in paragraph (f)(5)(i) of § 1.1248–3.

(c) *Foreign taxes.* (1) If the taxpayer fails to establish any portion of the amount of any foreign taxes which he is required to establish by subparagraph (2) of this paragraph, then such portion shall not be taken into account under section 1248(b)(1)(B):

(2) The taxpayer shall establish in respect of the stock he sells or exchanges the amount of the foreign taxes described in section 1248(b)(1)(B) paid by the first tier corporation for each taxable year of such corporation for which the information is required under paragraph (b) (3) or (4) of this section, and the amount of such taxes paid by each lower tier corporation for each taxable year (as to which information is required under paragraph (b) (3)(iv) or (5) of this section) of each such lower tier corporation. A taxpayer shall be considered to have established the amount of such foreign taxes if:

(i) He attaches to the schedule described in paragraph (b) of this section a supplementary schedule which, except to the extent provided in paragraph (e) of this section, sets forth the amount of such foreign taxes for each taxable year (of the first tier corporation and of each such lower tier corporation) as to which such amount must be established under this subparagraph, and

(ii) He establishes in the manner prescribed by paragraph (d)(2) of this section the correctness of each amount shown on such supplementary schedule.

(d) *Establishing amounts on schedules.* (1) A taxpayer shall be considered to have established, in respect of the stock he sold or exchanged, the correctness of an amount shown on a schedule described in paragraph (b) of this section only if he produces or provides within 180 days after demand by the district director (or within such

longer period to which such director consents):

(i) The books of original entry, or similar systematic accounting records maintained by any person or persons on a current basis as supplements to such books, which establish to the satisfaction of the district director the correctness of each such amount, and

(ii) In respect of any such books or records which are not in the English language, either an accurate English translation of any such records as are demanded, or the services of a qualified interpreter satisfactory to such director.

(2) A shareholder shall be considered to have established in respect of such stock the correctness of an amount shown on a supplementary schedule described in paragraph (c) of this section only if he produces or provides within 180 days after demand by the district director (or within such longer period to which such director consents):

(i) Evidence described in paragraph (a)(2) of § 1.905–2 of such amount, or

(ii) Secondary evidence of such amount, in the same manner and to the same extent as would be permissible under paragraph (b) of § 1.905–2 in the case of a taxpayer who claimed the benefits of the foreign tax credit in respect of such amount.

(e) *Insufficient information at time return is filed.* If stock in a foreign corporation, which was a controlled foreign corporation, is sold or exchanged by a taxpayer during a taxable year of the corporation (or of a lower tier corporation) which ends after the last day of the taxpayer's taxable year in which the sale or exchange occurs, and if:

(1) For the taxpayer's taxable year, the last day referred to in paragraph (a)(1) of this section for filing his income tax return with a schedule prescribed in paragraph (b) of this section, and, if applicable, with a supplemental schedule prescribed in paragraph (c) of this section, or

(2) The last day referred to in paragraph (a)(1) of this section (that is, April 1, 1965) for filing any such schedule or schedules with the district director with whom such return was filed,

Is not later than 90 days after the close of such taxable year of any such corporation, then such return with such schedule or schedules may be filed, or any such schedule or schedules may be filed, on the basis of estimates of amounts or percentages (for any such taxable year of any such corporation) required to be shown on any such schedule or schedules. If any such estimate differs from the actual amount or percentage, the taxpayer shall, within 90 days after the close of any such taxable year of any such corporation, file (or attach to a claim for refund or amended return filed) at the office of the district director with whom he filed the return a new schedule or schedules showing the actual amounts or percentages.

[T.D. 6779, 29 FR 18143, Dec. 22, 1964, as amended by T.D. 9345, 72 FR 41445, July 30, 2007: T.D. 9614, 78 FR 17041, Mar. 19, 2013]

§ 1.1248–8 Earnings and profits attributable to stock following certain non-recognition transactions.

(a) *Scope.* This section sets forth rules for the attribution of earnings and profits for purposes of section 1248 and § 1.1248–1(a)(1) and to supplement the rules in §§ 1.1248–2 and 1.1248–3 with respect to—

(1) *Stock that an exchanging shareholder receives, or an acquiring corporation receives, in restructuring transactions.* Except as otherwise provided in this paragraph (a), stock of a foreign corporation that an exchanging shareholder receives, or an acquiring corporation receives, pursuant to a restructuring transaction (as defined in paragraph (b)(1)(vii) of this section) in which the holding period of such stock is determined by application of section 1223(1) or 1223(2), whichever is appropriate. This section shall not apply to an exchange otherwise described in this paragraph (a)(1) if, as a result of the exchange, the exchanging shareholder is required to include in income as a deemed dividend the section 1248 amount pursuant to § 1.367(b)–4(b). See paragraphs (b)(2) and (3) of this section;

(2) *Nonexchanging shareholders.* Stock of a foreign corporation that participates in a restructuring transaction that is held by a non-exchanging shareholder (as defined in paragraph (b)(1)(vi) of this section) in the restructuring transaction. See paragraph (b)(4) of this section;

(3) *Section 381 transactions.* Stock of a foreign corporation that receives assets in a transfer to which section 361(a) or (b) applies in connection with a reorganization described in section 368(a)(1)(A), (C), (D), (F), or (G), or in a distribution to which section 332 applies, and to which section 381(c)(2)(A) and §1.381(c)(2)–1(a) apply. See paragraph (b)(6) of this section; or

(4) *Section 332 liquidations.* Stock of a foreign corporation that receives the assets and liabilities of a foreign corporation in a complete liquidation described in section 332 if the foreign distributee is a foreign corporate shareholder (as defined in paragraph (b)(1)(v) of this section) of the liquidating corporation. See paragraph (c) of this section.

(b) *Earnings and profits attributable to stock following a restructuring transaction*—(1) *Definitions.* The following definitions apply for purposes of this section:

(i) *Acquired corporation* is a corporation whose stock or assets are acquired in exchange for stock in (or stock in and other property of) either the acquiring corporation or a foreign corporation that controls, within the meaning of section 368(c), the acquiring corporation in a restructuring transaction.

(ii) *Acquiring corporation* is a corporation that acquires the stock or assets of an acquired corporation in a restructuring transaction.

(iii) *Controlled foreign corporation* is a corporation described in either section 953(c)(1)(B) or section 957.

(iv) *Exchanging shareholder* is a person that exchanges—

(A) In a restructuring transaction qualifying as a nonrecognition transaction within the meaning of section 7701(a)(45) and described in section 354, 356, or 361(a) or (b), stock in an acquired corporation for stock in either a foreign acquiring corporation or a foreign corporation that is in control, within the meaning of section 368(c), of an acquiring corporation (whether domestic or foreign); or

(B) In a restructuring transaction qualifying as a nonrecognition transaction within the meaning of section 7701(a)(45) and described in section 351, property (including stock) for stock in a foreign acquiring corporation.

(v) *Foreign corporate shareholder* is a foreign corporation that—

(A) Owns stock of another foreign corporation; and

(B) Has a section 1248 shareholder that is also a section 1248 shareholder of the other foreign corporation.

(vi) *Non-exchanging shareholder* is, at the time the acquiring corporation participates in a restructuring transaction, either a section 1248 shareholder or a foreign corporate shareholder of the acquiring corporation that is not an exchanging shareholder with respect to that corporation.

(vii) *Restructuring transaction* is a transaction qualifying as a nonrecognition transaction within the meaning of section 7701(a)(45) and described in section 351, 354, 356, or 361.

(viii) *Section 1248 shareholder* is any United States person that satisfies the ownership requirements of section 1248(a)(2) and §1.1248–1(a)(2) with respect to a foreign corporation.

(2) *Earnings and profits attributable to stock that an exchanging shareholder receives in a restructuring transaction.* Where, in a restructuring transaction, an exchanging shareholder receives stock in a foreign corporation, the holding period of which is determined under section 1223(1), and the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder with respect to that foreign corporation immediately after the restructuring transaction, the earnings and profits attributable to the stock the exchanging shareholder receives shall be determined pursuant to the rules in paragraphs (b)(2)(i), (ii), and (iii) of this section.

(i) *Exchanging shareholder exchanges property that is not stock of a foreign acquired corporation with respect to which the exchanging shareholder is a section 1248 shareholder or a foreign corporate shareholder.* Except as provided in paragraph (b)(2)(iv) of this section, where the exchanging shareholder exchanges in a restructuring transaction property that is not stock of a foreign acquired corporation with respect to which the exchanging shareholder is a section 1248 shareholder or a foreign corporate shareholder immediately before the

transaction, the earnings and profits attributable to the stock that the exchanging shareholder receives in the restructuring transaction will be determined in accordance with § 1.1248–2 or § 1.1248–3, whichever is applicable, without regard to any portion of the section 1223(1) holding period in that stock that is before the restructuring transaction. See paragraph (b)(7), *Example 1* of this section.

(ii) *Exchanging shareholder exchanges stock of a foreign corporation with respect to which the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder.* Except as provided in paragraph (b)(2)(iii) of this section, where the exchanging shareholder exchanges in a restructuring transaction stock of a foreign acquired corporation with respect to which the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder immediately before such restructuring transaction, the earnings and profits attributable to the stock that the exchanging shareholder receives in the restructuring transaction shall be the sum of the earnings and profits attributable to—

(A) The stock of the foreign acquired corporation exchanged (determined in accordance with § 1.1248–2 or § 1.1248–3, whichever is applicable, and this section, if applicable) that was accumulated before the restructuring transaction; and

(B) The stock of the foreign corporation that the exchanging shareholder receives in the restructuring transaction (determined in accordance with § 1.1248–2 or § 1.1248–3, whichever is applicable, and this section, if applicable), without regard to any portion of the section 1223(1) holding period in that stock that is prior to the restructuring transaction. See paragraph (b)(7) *Example 2*, *Example 4*, and *Example 6* of this section.

(iii) *Exchanging shareholder receives stock in a foreign corporation that controls a domestic acquiring corporation.* Where the acquiring corporation is a domestic corporation and the exchanging shareholder receives in a restructuring transaction stock in a foreign corporation that controls (within the meaning of section 368(c)) the domestic acquiring corporation, the earnings and profits attributable to the stock that the exchanging shareholder receives in the restructuring transaction shall consist solely of the amount of earnings and profits attributable to such stock (determined in accordance with § 1.1248–2 or § 1.1248–3, whichever is applicable, and this section, if applicable) without regard to any portion of the section 1223(1) holding period in that stock that is prior to the restructuring transaction. See paragraph (b)(7) *Example 5* of this section.

(iv) *Exchanging shareholder exchanges stock of a domestic acquired corporation for stock of a foreign corporation with respect to which the exchanging shareholder is a section 1248 shareholder after the exchange.* If there is a restructuring transaction described in § 1.1248(f)–1(b)(3) to which the exception provided by § 1.1248(f)–2(c) applies with respect to a distribution by a domestic acquired corporation of stock of a foreign corporation to one or more exchanging shareholders, the earnings and profits attributable to a portion of a share of stock as provided under § 1.1248(f)–2(c)(2) (or a whole share, if no division is required) will be determined pursuant to paragraphs (b)(2)(iv)(A) and (b)(2)(iv)(B) of this section.

(A) The earnings and profits attributable to a portion of a share of stock as provided under § 1.1248(f)–2(c)(2)(i) (or a whole share, if no division is required) will be determined in accordance with § 1.1248–2 or § 1.1248–3 (and this section, as applicable), without regard to any portion of the section 1223(1) holding period in that portion of a share (or whole share) that is before the restructuring transaction.

(B) The earnings and profits attributable to a portion of a share of stock as provided under § 1.1248(f)–2(c)(2)(ii) (or whole share, if no division is required) is the amount in paragraph (b)(2)(iv)(B)(*1*) of this section, increased by the amounts described in paragraph (b)(2)(iv)(B)(*2*) of this section.

(*1*) The amount equal to the product of the ratio of the value of the share of stock to the value of all shares of stock received by the exchanging shareholder multiplied by the amount in paragraph (b)(2)(iv)(B)(*1*)(*i*) of this section, reduced by the amount in paragraph (b)(2)(iv)(B)(*1*)(*ii*) of this section.

(*i*) The amount equal to the product of the exchanging shareholder's ownership interest percentage (within the meaning of §1.367(a)–7(f)(7)) in the domestic acquired corporation multiplied by the earnings and profits attributable to the block of stock of the foreign corporation transferred in the section 361 exchange that relates to the portion (or whole share), determined in accordance with §1.1248–2 or §1.1248–3 (and this section, as applicable) immediately before the restructuring transaction (and without taking into account the application of sections 367 and 1248 to the transfer of the stock of the foreign corporation in the section 361 exchange).

(*ii*) The amount of any dividend included in the domestic acquiring corporation's gross income under section 1248(a) on the transfer of the block of stock of the foreign corporation, which relates to the portion or whole share, in the section 361 exchange by reason of gain recognized under §§1.367(a)–6 or 1.367(a)–7(c)(2) attributable to the exchanging shareholder.

(*2*) The earnings and profits determined in accordance with §1.1248–2 or §1.1248–3 (and this section, as applicable), without regard to any portion of the section 1223(1) holding period in that stock that is before the restructuring transaction. See §1.1248(f)–2(e), *Example 2* and *Example 3*.

(3) *Earnings and profits attributable to stock in a foreign corporation certain acquiring corporations receive in a restructuring transaction*. Where an acquiring corporation receives, in a restructuring transaction, stock in a foreign acquired corporation, the holding period of which is determined under section 1223(2), and the acquiring corporation is either a section 1248 shareholder or a foreign corporate shareholder with respect to that foreign acquired corporation immediately after the restructuring transaction, the earnings and profits attributable to the foreign acquired corporation stock that the acquiring corporation receives shall be determined pursuant to the rules in paragraphs (b)(3)(i) and (ii) of this section.

(i) *Stock of a foreign corporation with respect to which the exchanging shareholder is neither a section 1248 shareholder nor a foreign corporate shareholder*. The earnings and profits attributable to the stock of the foreign acquired corporation that the acquiring corporation receives in a restructuring transaction where the exchanging shareholder is neither a section 1248 shareholder nor a foreign corporate shareholder with respect to that foreign acquired corporation immediately before the restructuring transaction shall be determined in accordance with §1.1248–2 or §1.1248–3, whichever is applicable, without regard to any portion of the section 1223(2) holding period in that stock that is prior to the restructuring transaction.

(ii) *Stock of a foreign corporation with respect to which the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder*. The earnings and profits attributable to the stock of a foreign acquired corporation that the acquiring corporation receives in the restructuring transaction where the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder with respect to that foreign corporation immediately before the restructuring transaction shall be determined in accordance with §1.1248–2 or §1.1248–3, whichever is applicable, with regard to the portion of the section 1223(2) holding period of the stock that the exchanging shareholder took into account for purposes of attributing earnings and profits to that stock (determined in accordance with this section). See paragraph (b)(7) *Example 3*, *Example 5*, and *Example 7* of this section.

(4) *Earnings and profits attributable to stock held by a non-exchanging shareholder in a foreign acquiring corporation*. (i) Except to the extent paragraph (b)(4)(ii) of this section applies, the earnings and profits attributable to stock of a foreign acquiring corporation held by a non-exchanging shareholder immediately prior to a restructuring transaction continue to be attributed to such stock, and the earnings and profits of the acquired corporation accumulated prior to the restructuring transaction attributable to the stock of an acquired corporation are not attributed to the non-exchanging shareholder's stock in the foreign acquiring corporation. See §1.1248–2 or

§ 1.1248–3 (whichever is applicable) and, as applicable, paragraph (b)(6) of this section; see also paragraph (b)(7) *Example 2* and *Example 4* of this section.

(ii) Where a non-exchanging shareholder holds stock in a foreign corporation that is also an exchanging shareholder and a foreign acquiring corporation in the same restructuring transaction—

(A) The earnings and profits attributable to such stock shall be the sum of the earnings and profits attributable to the stock of such foreign corporation immediately before the restructuring transaction (including amounts attributed under section 1248(c)(2)) and the earnings and profits attributable to the stock of the foreign acquiring corporation accumulated after the restructuring transaction (including amounts attributed under section 1248(c)(2)); and

(B) Paragraph (b)(6) of this section applies. See paragraph (b)(7) *Example 8* of this section.

(iii) Where the acquiring corporation is a foreign corporate shareholder with respect to stock of a foreign acquired corporation, paragraph (b)(3) of this section shall not apply for purposes of determining the earnings and profits attributable to stock in the foreign acquiring corporation owned by a non-exchanging shareholder thereof (see section 1248(c)(2)). See paragraph (b)(7) *Example 6* of this section.

(5) *Reduction in earnings and profits attributable to stock to prevent multiple inclusions with respect to the same earnings and profits.* To the extent consistent with the principles of section 1248, adjustments to earnings and profits attributable to stock shall be made such that section 1223(1) and (2) and this section are applied in a manner that results in earnings and profits being taken into account only once. Thus, for example, when a controlled foreign corporation sells or exchanges all or part of the stock of another foreign corporation to which earnings and profits are attributable pursuant to this paragraph (b) or paragraph (c) of this section, proportionate reductions shall be made to the earnings and profits attributed to the stock of the selling foreign corporate shareholder owned by a section 1248 shareholder. See paragraph (b)(7) *Example 7* of this section.

(6) *Special rule regarding section 381.* Solely for purposes of determining the earnings and profits (or deficit in earnings and profits) attributable to stock pursuant to this paragraph (b), the earnings and profits of a corporation shall not include earnings and profits that are treated as received or incurred under section 381(c)(2)(A) and § 1.381(c)(2)–1(a). See paragraph (b)(7) *Example 4* of this section.

(7) *Examples.* The application of this paragraph (b) is illustrated by the following examples. Unless otherwise indicated, in the following examples assume that—

(i) There is no immediate gain recognition pursuant to section 367(a)(1) and the regulations under that section (either through operation of the rules or because the appropriate parties have entered into a gain recognition agreement under §§ 1.367(a)–3(b) and 1.367(a)–8);

(ii) There is no income inclusion required pursuant to section 367(b) and the regulations under that section, and all reporting requirements in those regulations are complied with;

(iii) References to earnings and profits are to earnings and profits that would be includible in income as a dividend under section 1248 and the regulations under that section if stock to which the earnings and profits are attributable were sold or exchanged by its shareholder;

(iv) Each corporation has only a single class of stock outstanding and uses the calendar year as its taxable year; and

(v) Each transaction is unrelated to all other transactions.

Example 1. A section 351 exchange of property other than stock in a foreign corporation with respect to which the exchanging shareholder is either a section 1248 shareholder or a foreign corporate shareholder. (i) *Facts.* DC1, a domestic corporation, has owned all the stock of CFC, a foreign corporation, since CFC's formation on January 1, year 3. On December 31, year 5, DC2, a domestic corporation unrelated to DC1, contributes property it has held since January 1, year 1, to CFC in exchange for voting stock of CFC in a restructuring transaction that is an exchange under section 351. The property that DC2 contributes is not stock in a foreign corporation

with respect to which DC2 was either a section 1248 shareholder or a foreign corporate shareholder. DC2 receives 80% of the voting stock of CFC in the restructuring transaction and its holding period in that CFC stock, determined pursuant to section 1223(1), began on January 1, year 1. CFC has $100 of accumulated earnings and profits on December 31, year 5. On December 31, year 7, when the accumulated earnings and profits of CFC are $200, DC2, a section 1248 shareholder with respect to CFC, sells its CFC stock.

(ii) *Result*. Under paragraph (b)(2)(i) of this section, the earnings and profits attributable to the CFC stock sold by DC2 are $80. This amount consists of none of the $100 of earnings and profits accumulated by CFC before the restructuring transaction, and 80% of the $100 of earnings and profits of CFC accumulated after the restructuring transaction.

Example 2. A section 351 exchange of controlled foreign corporation stock by a United States person for stock in a controlled foreign corporation in a restructuring transaction. (i) *Facts*. The facts are the same as in *Example 1* except as follows. The property that DC2 contributes is 100% of the stock in CFC2, a foreign corporation. DC2 has owned all the stock of CFC2 since CFC2's formation on January 1, year 2, and CFC2 has $200 of earnings and profits as of December 31, year 5. CFC2 does not accumulate any additional earnings and profits from December 31, year 5, to December 31, year 7. On December 31, year 7, when the accumulated earnings and profits of CFC are $200, DC2, a section 1248 shareholder with respect to CFC, sells its CFC stock. Also on that date, DC1 sells its CFC stock.

(ii) *Result*. (A) *DC2 sale*. Pursuant to paragraph (b)(2)(ii) of this section, the earnings and profits attributable to the CFC stock sold by DC2 are $280. This amount consists of all of the $200 of earnings and profits of CFC2 accumulated before the restructuring transaction (see also section 1248(c)(2)), none of the $100 of earnings and profits accumulated by CFC before the restructuring transaction, and 80% of the $100 of earnings and profits of CFC accumulated after the restructuring transaction.

(B) *DC1 sale*. Pursuant to paragraph (b)(4) of this section, the earnings and profits attributable to the CFC stock sold by DC1, a non-exchanging shareholder in the restructuring transaction, are $120. This amount consists of all of the $100 of earnings and profits of CFC accumulated before the restructuring transaction, none of the $200 of earnings and profits of CFC2 accumulated before the restructuring transaction, and 20% of the $100 of earnings and profits of CFC accumulated after the restructuring transaction.

Example 3. A section 351 exchange of controlled foreign corporation stock by a United States person for stock in a domestic corporation in a restructuring transaction. (i) *Facts*. DC1, a domestic corporation, has owned all of the stock of CFC, a foreign corporation, since CFC's formation on January 1, year 1. DC1 has also owned all the stock of DC2, a domestic corporation, since DC2's formation on January 1, year 1. On December 31, year 2, DC1 contributes the stock of CFC to DC2 in exchange for stock in DC2 in a restructuring transaction that is an exchange described in section 351. On December 31, year 2, CFC has $100 of accumulated earnings and profits. DC2 has a basis in the CFC stock determined under section 362, and is considered to have held the CFC stock since January 1, year 1, pursuant to section 1223(2). On December 31, year 4, when the accumulated earnings and profits of CFC are still $100, DC2 sells its CFC stock.

(ii) *Result*. Under paragraph (b)(3)(ii) of this section, $100 of accumulated earnings and profits of CFC is attributable to the stock of CFC sold by DC2, even though DC2 did not hold the stock of CFC during the time CFC accumulated the earnings and profits.

Example 4. Acquisition of a controlled foreign corporation by a controlled foreign corporation in a reorganization described in section 368(a)(1)(C) (or section 368(a)(1)(B)). (i) *Facts*. DC1, a domestic corporation, has owned all the stock of CFC1, a foreign corporation, since its formation on January 1, year 1. DC2, a domestic corporation unrelated to DC1, has owned all of the stock of CFC2, a foreign corporation, since its formation on January 1, year 2. On December 31, year 3, pursuant to a restructuring transaction that is a reorganization described in section 368(a)(1)(C), CFC1 transfers all of its assets to CFC2 in exchange for 25% of the voting stock of CFC2. CFC1 distributes the CFC2 stock to DC1 and the CFC1 stock is cancelled. DC1's holding period in the CFC2 stock, determined under section 1223(1), begins on January 1, year 1. On December 31, year 3, CFC1 has $100 of accumulated earnings and profits and CFC2 has $200 of accumulated earnings and profits. CFC2 succeeds to the $100 of CFC1 accumulated earnings and profits in the reorganization under section 381. From January 1, year 4 to December 31, year 5, CFC2 incurred a deficit in earnings and profits in the amount of ($200). On December 31, year 5, both DC1 and DC2 sell their stock in CFC2.

(ii) *Result*. (A) *DC1*. Pursuant to paragraph (b)(2)(ii) of this section, $50 of earnings and profits is attributable to the CFC2 stock sold by DC1. This amount consists of $100 of CFC1's earnings and profits accumulated before the restructuring transaction, reduced by 25% of CFC2's ($200) post-restructuring transaction deficit in earnings and profits. None of the $200 of CFC2's earnings and profits accumulated by CFC2 prior to the reorganization is attributed to the CFC2 stock sold

by DC1. Also, none of the earnings and profits CFC2 succeeded to under section 381 is attributed to the CFC2 stock sold by DC1, pursuant to paragraph (b)(6) of this section.

(B) *DC2*. Pursuant to paragraph (b)(4) of this section, there is $50 of accumulated earnings and profits attributable to the CFC2 stock sold by DC2. This amount consists of all of the $200 of CFC2's earnings and profits accumulated by CFC2 prior to the reorganization, reduced by 75% of CFC2's deficit in earnings and profits in the amount of ($200) incurred after the restructuring transaction. None of the $100 of CFC1 accumulated earnings and profits succeeded to under section 381 is attributable to the CFC2 stock sold by DC2, pursuant to paragraph (b)(6) of this section.

(C) *Section 368(a)(1)(B) reorganization*. If, instead of DC1 acquiring its 25% interest in CFC2 pursuant to a reorganization described in section 368(a)(1)(C), DC1 had transferred the stock of CFC1 to CFC2 in exchange for 25% of the voting stock of CFC2 in a reorganization described in section 368(a)(1)(B), the results would be the same as described in paragraphs (ii) (A) and (B) of this *Example 4*.

Example 5. Acquisition of the stock of a foreign corporation that controls a domestic acquiring corporation in a triangular reorganization described in section 368(a)(1)(C). (i) *Facts*. DC1, a domestic corporation, has owned all the stock of CFC1, a foreign corporation, since its formation on January 1, year 1. CFC1 has owned all the stock of CFC2, a foreign corporation, since its formation on January 1, year 1. FC, a foreign corporation that is not a controlled foreign corporation, has owned all of the stock of DC2, a domestic corporation, since its formation on January 1, year 2. On December 31, year 3, pursuant to a restructuring transaction that was a triangular reorganization described in section 368(a)(1)(C), CFC1 transfers all of its assets, including the CFC2 stock, to DC2 in exchange for 60% of the voting stock of FC. CFC1 transfers the voting stock of FC to DC1 and the CFC1 stock is cancelled. Pursuant to section 1223(1), DC1 is considered to have held the stock of FC since January 1, year 1. Under section 1223(2), DC2 is considered to have held the stock of CFC2 since January 1, year 1. On December 31, year 3, CFC1 has $100 of earnings and profits, CFC2 has $300 of earnings and profits, and FC has $200 of earnings and profits. DC1 includes the $100 all earnings and profits amount attributable to its CFC1 stock in income as a deemed dividend under §1.367(b)–3 upon the exchange of CFC1 stock for FC stock. Pursuant to the lower-tier earnings exclusion of §1.367(b)–2(d)(3)(ii), that amount does not include the $300 of earnings and profits of CFC2. From January 1, year 4, until December 31, year 5, FC (now a controlled foreign corporation) accumulates an additional $50 of earnings and profits. From January 1, year 4 until December 31, year 5, CFC2 accumulates an additional $100 of earnings and profits. On December 31, year 5, DC1 sells its stock in FC and DC2 sells its stock in CFC2.

(ii) *Result*. (A) *DC1*. Pursuant to paragraph (b)(2)(iii) of this section, there is $30 of earnings and profits attributable to the stock of FC sold by DC1. This amount consists of 60% of the $50 of earnings and profits accumulated by FC after the restructuring transaction, and none of the earnings and profits accumulated by CFC1, CFC2, or FC before the restructuring transaction.

(B) *DC2*. Pursuant to paragraph (b)(3)(ii) of this section, there is $400 of earnings and profits attributable to the stock of CFC2 sold by DC2. This amount consists of all of the earnings and profits accumulated by CFC2 during DC2's section 1223(2) holding period.

Example 6. Acquisition of the stock of a foreign corporation that controls a foreign acquiring corporation in a reorganization described in section 368(a)(1)(C). (i) *Facts*. DC1, a domestic corporation, has owned all the stock of CFC1, a foreign corporation, since its formation on January 1, year 1. CFC1 has owned all the stock of CFC2, a foreign corporation, since its formation on January 1, year 1. FC, a foreign corporation that is not a controlled foreign corporation, has owned all of the stock of FC2, a foreign corporation, since its formation on January 1, year 2. On December 31, year 3, pursuant to a restructuring transaction that was a triangular reorganization described in section 368(a)(1)(C), CFC1 transfers all of its assets, including the CFC2 stock, to FC2 in exchange for 60% of the voting stock of FC. CFC1 transfers the voting stock of FC to DC1 and the CFC1 stock is cancelled. Pursuant to section 1223(1), DC1 is considered to have held the stock of FC since January 1, year 1. Under section 1223(2), FC2 is considered to have held the stock of CFC2 since January 1, year 1. On December 31, year 3, CFC1 has $100 of earnings and profits, CFC2 has $300 of earnings and profits, FC has $200 of earnings and profits, and FC2 has no earnings and profits. From January 1, year 4, until December 31, year 5, FC (now a controlled foreign corporation) accumulates an additional $50 of earnings and profits. From January 1, year 4 until December 31, year 5, CFC2 accumulates an additional $100 of earnings and profits. FC2, a controlled foreign corporation after the restructuring transaction, accumulates $100 of earnings and profits from January 1, year 4, until December 31, year 5. On December 31, year 5, DC1 sells its stock in FC.

(ii) *Result*. Pursuant to paragraphs (b)(2)(ii) and (b)(4)(iii) of this section, there is $550 of earnings and profits attributable to the stock of FC sold by DC1. This amount consists of all $400 of the CFC1 and CFC2 earnings and profits accumulated before the restructuring transaction (see also section 1248(c)(2)), and 60% of the $250 of the earnings

and profits accumulated by FC, FC2, and CFC2 after the restructuring transaction.

Example 7. Acquisition of controlled foreign corporation stock by a controlled foreign corporation in a reorganization described in section 368(a)(1)(B), followed by a sale of the acquired stock by the acquiring controlled foreign corporation. (i) *Facts.* DC1, a domestic corporation, has owned all of the outstanding stock of CFC1, a foreign corporation, since its formation on January 1, year 1. CFC1 has owned all of the outstanding stock of CFC3, a foreign corporation, since its formation on January 1, year 1. DC2, a domestic corporation unrelated to DC1, has owned all of the outstanding stock of CFC2, a foreign corporation, since its formation on January 1, year 2. On December 31, year 3, pursuant to a restructuring transaction that is a reorganization described in section 368(a)(1)(B), CFC1 transfers all of the stock of CFC3 to CFC2 in exchange for 40% of CFC2's stock. On December 31, year 3, CFC2 and CFC3 have, respectively, $40 and $20 of earnings and profits. On December 31, year 5, when the accumulated earnings and profits of CFC3 are $50 ($20 of earnings and profits as of December 31, year 3, plus $30 of earnings and profits generated from January 1, year 4, through December 31, year 5), CFC2 sells the stock of CFC3 in a transaction to which section 964(e) applies.

(ii) *Result.* (A) *CFC2.* Pursuant to paragraph (b)(3)(ii) of this section, there is $50 of earnings and profits attributable to the CFC3 stock sold by CFC2. This amount consists of the accumulated earnings and profits attributable to CFC2's entire section 1223(2) holding period in the CFC3 stock.

(B) *CFC1, DC2, and DC1.* Under paragraph (b)(5) of this section, the earnings and profits attributable to the CFC2 stock held by CFC1 and DC2, and the earnings and profits attributable to the CFC1 stock held by DC1, will be reduced (regardless of whether CFC2 recognizes gain on its sale of CFC3 stock).

(*1*) *CFC1.* The earnings and profits attributable to the CFC2 stock held by CFC1 will be reduced by $32, or the amount of earnings and profits as of December 31, year 5, that would have been attributable to the CFC2 stock held by CFC1 pursuant to paragraph (b)(2)(ii) of this section. This amount consists of all of the $20 of earnings and profits accumulated by CFC3 before the restructuring transaction and 40% of the $30 of earnings and profits accumulated by CFC3 after the restructuring transaction (.40 × $30 = $12).

(*2*) *DC1.* The earnings and profits attributable to the CFC1 stock held by DC1 will also be reduced by $32, or the amount of earnings and profits that would have been attributable to the CFC1 stock held by DC1 as of December 31, year 5.

(*3*) *DC2.* The earnings and profits attributable to the CFC2 stock held by DC2 will be reduced by $18, or the amount of earnings and profits that would have been attributable to the CFC2 stock held by DC2 as of December 31, year 5, under paragraph (b)(4) of this section. This amount consists of 60% of the $30 (.60 × $30 = $18) of earnings and profits accumulated by CFC3 after the restructuring transaction.

(C) *Partial sale by CFC2.* If, instead of selling 100% of the CFC3 stock, on December 31, year 5, CFC2 sells only 50% of its CFC3 stock, paragraph (b)(5) of this section requires CFC1 to reduce the earnings and profits of CFC3 attributable to its CFC2 stock to $16. Similarly, DC1 would be required to reduce the earnings and profits of CFC3 attributable to its CFC1 stock by $16. Paragraph (b)(5) of this section also requires DC2 to reduce the CFC3 earnings and profits attributable to its CFC2 stock by $9. These reductions occur without regard to whether CFC2 recognizes gain on its sale of CFC3 stock.

Example 8. Acquisition of the assets of a lower-tier controlled foreign corporation by an upper-tier controlled foreign corporation in a restructuring transaction described in section 368(a)(1)(C). (i) *Facts.* DC, a domestic corporation, has owned all the stock of CFC1, a controlled foreign corporation, since its formation on January 1, year 1. CFC1 is a holding company that has owned 79% of the stock of CFC2, a controlled foreign corporation, since its formation on January 1, year 1. The other 21% of CFC2 stock is owned by X, an unrelated party. On December 31, year 1, CFC2 has $200 of earnings and profits. On December 31, year 1, CFC1 has no accumulated earnings and profits. On December 31, year 1, pursuant to a restructuring transaction described in section 368(a)(1)(C), CFC2 transfers all its properties to CFC1. In exchange, CFC1 assumes the liabilities of CFC2 and transfers to CFC2 voting stock representing 21% of the stock of CFC1. CFC2 distributes the voting stock to X and liquidates. The liabilities assumed do not exceed 20% of the value of the properties of CFC2. From January 1, year 2, to December 31, year 3, CFC1 accumulates $100 of earnings and profits. On December 31, year 3, DC sells its CFC1 stock.

(ii) *Result.* Pursuant to paragraph (b)(4)(ii) of this section, there is $237 of earnings and profits attributable to DC's CFC1 stock. This amount consists of 79% of CFC2's $200 of earnings and profits accumulated before the restructuring transaction (see section 1248(c)(2)), and 79% of CFC1's $100 of earnings and profits accumulated after the restructuring transaction. Pursuant to paragraph (b)(6) of this section, none of CFC2's $200 of earnings and profits to which CFC1 succeeded under section 381 would be attributable to DC's CFC1 stock.

(c) *Earnings and profits attributable to stock of a foreign distributee corporation that is a foreign corporate shareholder with respect to a foreign liquidating corporation*—(1) *General rule.* If a foreign

corporation (liquidating corporation) makes a distribution of property in complete liquidation under section 332 to a foreign corporation (distributee), and immediately before the liquidation the distributee was a foreign corporate shareholder with respect to the liquidating foreign corporation, the amount of earnings and profits attributable to the distributee stock upon its subsequent sale or exchange will be determined under this paragraph (c)(1). The earnings and profits attributable will be the sum of the earnings and profits attributable to the stock of the distributee immediately before the liquidation (including amounts attributed under section 1248(c)(2)) and the earnings and profits attributable to the stock of the distributee accumulated after the liquidation (including amounts attributed under section 1248(c)(2)).

(2) *Special rule regarding section 381.* Solely for purposes of determining the earnings and profits (or deficit in earnings and profits) attributable to stock under this paragraph (c), the attributed earnings and profits of a corporation shall not include earnings and profits that are treated as received or incurred pursuant to section 381(c)(2)(A) and § 1.381(c)(2)–1(a).

(3) *Example*— (i) *Facts.* DC, a domestic corporation, has owned all of the stock of CFC1, a foreign corporation, since its formation on January 1, year 1. CFC1 is an operating company that has owned all of the stock of CFC2, a foreign corporation, since its formation on January 1, year 1. On December 31, year 2, CFC1 has $200 of accumulated earnings and profits and CFC2 has a ($200) deficit in earnings and profits. On December 31, year 2, CFC2 distributes all of its assets and liabilities to CFC1 in a liquidation to which section 332 applies. From January 1, year 3, until December 31, year 4, CFC1 accumulates no additional earnings and profits. On December 31, year 4, DC sells its stock in CFC1.

(ii) *Result.* Pursuant to paragraph (c)(1) of this section, there are no earnings and profits attributable to DC's CFC1 stock. This amount consists of the sum of the earnings and profits attributable to the CFC1 stock immediately before the liquidation (100% of the $200 accumulated earnings and profits of CFC1 and 100% of CFC2's ($200) deficit in earnings and profits) and the amount of earnings and profits accumulated after the section 332 liquidation (see also section 1248(c)(2)).

(d) *Effective/applicability dates*—(1) *General rule.* Except as provided in paragraph (d)(2) of this section, this section applies to income inclusions that occur on or after July 30, 2007.

(2) *Exception.* Paragraph (b)(2)(iv) of this section applies to restructuring transactions occurring on or after April 18, 2013.

[T.D. 9345, 72 FR 41446, July 30, 2007, as amended by T.D. 9614, 78 FR 17042, Mar. 19, 2013; T.D. 9803, 81 FR 91030, Dec. 16, 2016]

§ 1.1248(f)–1 Certain nonrecognition distributions.

(a) *Scope and purpose.* This section and §§ 1.1248(f)–2 and 1.1248(f)–3 provide rules under section 1248(f) that apply when a domestic corporation (domestic distributing corporation) distributes stock of a foreign corporation (foreign distributed corporation) in a distribution to which section 337, 355(c)(1), or 361(c)(1) applies. Paragraph (b) of this section provides the general rule that requires the domestic distributing corporation, depending on the type of distribution, to include in gross income either the section 1248 amount or the total section 1248(f) amount. Paragraph (c) of this section provides definitions that apply for purposes of this section and §§ 1.1248(f)–2 and 1.1248(f)–3. Section 1.1248(f)–2 provides exceptions to the general rule contained in paragraph (b) of this section that apply, depending on the type of distribution. Section 1.1248(f)–3 provides reasonable cause relief procedures for failures to timely comply with certain filing requirements and effective/applicability dates.

(b) *General rule*—(1) *Section 337 distribution.* This paragraph (b)(1) applies if a domestic distributing corporation that is a section 1248 shareholder of a foreign distributed corporation distributes stock of the foreign distributed corporation in a distribution to which section 337 applies (section 337 distribution). Except as provided in § 1.1248(f)–2(a), the domestic distributing corporation must, notwithstanding any other provision of subtitle A of the Internal

Revenue Code (Code), include in gross income as a dividend the section 1248 amount with respect to the stock of the foreign distributed corporation. This paragraph (b)(1) applies only to the extent the domestic distributing corporation does not recognize gain with respect to the stock of the foreign distributed corporation as a result of the section 337 distribution under another provision of subtitle A of the Code.

(2) *Existing stock distribution under section 355 or 361.* This paragraph (b)(2) applies to the extent a domestic distributing corporation distributes stock of the foreign distributed corporation that is not received in a section 361 exchange that is part of the plan of distribution, provided the distribution is described in section 355(c)(1) or section 361(c)(1) (existing stock distribution). Except as provided in §1.1248(f)–2(b), the domestic distributing corporation must, notwithstanding any other provision of subtitle A of the Code, include in gross income as a dividend the section 1248 amount with respect to the stock of the foreign distributed corporation. This paragraph (b)(2) only applies to the extent the domestic distributing corporation does not recognize gain with respect to the stock of the foreign distributed corporation as a result of the existing stock distribution under another provision of subtitle A of the Code.

(3) *New stock distribution under section 361.* This paragraph (b)(3) applies to the extent a domestic distributing corporation distributes stock of the foreign distributed corporation that is received in a section 361 exchange that is part of the plan of distribution (and, to the extent applicable, also distributes any cash or other property), provided the distribution is described in section 361(c)(1) (new stock distribution). Except as provided in §1.1248(f)–2(c), the domestic distributing corporation must, notwithstanding any other provision of subtitle A of the Code, include in gross income as a dividend the total section 1248(f) amount with respect to the stock of each foreign corporation transferred in the section 361 exchange. This paragraph (b)(3) applies without regard to the amount of gain realized by the domestic distributing corporation in the new stock distribution.

(c) *Definitions.* Except as otherwise provided, the following definitions apply for purposes of this section and §§1.1248(f)–2 and 1.1248(f)–3:

(1) *80-percent distributee* is a corporation described in section 337(c).

(2) *Block of stock* has the meaning provided in §1.1248–2(b).

(3) *Distributee* is a shareholder of the domestic distributing corporation that receives one or more shares of stock of a foreign distributed corporation in an existing stock distribution (as defined in paragraph (b)(2) of this section) or a new stock distribution (as defined in paragraph (b)(3) of this section).

(4) *Hypothetical section 1248 amount* is, with respect to each distributee or non-stock distributee, the amount in paragraph (c)(4)(i) of this section, reduced by the amount in paragraph (c)(4)(ii) of this section computed with respect to the stock of each foreign corporation transferred in the section 361 exchange by the domestic distributing corporation for which there is not an income inclusion under §1.367(b)–4(b)(1)(i).

(i) The amount that the domestic distributing corporation would have included in income as a deemed dividend under §1.367(b)–4(b)(1)(i) if the requirements of §1.367(b)–4(b)(1)(ii)(A) (involving the receipt of foreign stock in an exchange to which §1.367(a)–7(c) applies) had not been satisfied and that would have been attributable to such distributee or non-stock distributee under §1.367(a)–7(e)(4) (providing rules to attribute deemed income inclusions under §1.367(b)–4 to persons described in §1.367(a)–3(e)(3)(iii)(A).

(ii) The amount of gain recognized by the domestic distributing corporation under §1.367(a)–7(c)(2) attributable to such distributee or non-stock distributee and allocable to the stock of such foreign corporation under §1.367(a)–7(e)(1), but only to the extent such gain is treated as a dividend under section 1248(a).

(5) *Non-stock distributee* is a shareholder of the domestic distributing corporation that receives cash or other property but no shares of stock of the foreign distributed corporation in a new stock distribution (as defined in paragraph (b)(3) of this section).

(6) *Postdistribution amount* is the section 1248 amount with respect to the stock (or a portion of a share of stock) of the foreign distributed corporation received by a distributee, computed immediately after the distribution, but without taking into account any adjustments to the basis of the stock under § 1.1248(f)–2(b)(3) (in the case of an existing stock distribution) or adjustments to the basis of stock or income inclusions under § 1.1248(f)–2(c)(3) (in the case of a new stock distribution). The postdistribution amount in the stock of a foreign distributed corporation received in an existing stock distribution is determined based on the distributee's holding period in the stock as adjusted under § 1.1248(f)–2(b)(2). The postdistribution amount in the stock (or a portion of a share of stock, as applicable) of a foreign distributed corporation received in a new stock distribution is determined after applying the rules in §§ 1.1248–8(b)(2)(iv) and 1.1248(f)–2(c)(2).

(7) *Section 358 basis* is the basis in stock as determined under section 358.

(8) *Section 361 exchange* is an exchange described in section 361(a) or (b).

(9) *Section 1248 amount* is the net positive earnings and profits (if any) attributable to the stock of the foreign distributed corporation, determined in accordance with § 1.1248–2 or § 1.1248–3 (taking into account § 1.1248–8, if applicable), and that would be included in gross income as a dividend under section 1248(a) if the stock were sold by the domestic distributing corporation in a transaction in which all realized gain is recognized.

(10) *Section 1248(f) amount* is the amount in paragraph (c)(10)(i) of this section, reduced by the amount in paragraph (c)(10)(ii) of this section computed with respect to the stock of each foreign corporation transferred in the section 361 exchange by the domestic distributing corporation for which the domestic distributing corporation does not have an income inclusion under § 1.367(b)–4(b)(1)(i).

(i) The amount that the domestic distributing corporation would have included in income as a dividend under § 1.367(b)–4(b)(1)(i) if the requirements of § 1.367(b)–4(b)(1)(ii)(A) (involving the receipt of foreign stock in an exchange to which § 1.367(a)–7(c) applies) had not been satisfied.

(ii) The amount of gain recognized by the domestic distributing corporation under § 1.367(a)–7(c)(2) and allocable to the stock of such foreign corporation under § 1.367(a)–7(e)(1), but only to the extent such gain is treated as a dividend under section 1248(a).

(11) *Section 1248(f) block amount* is the portion of the section 1248(f) amount, as defined in paragraph (c)(10) of this section, that relates to a block of stock of the foreign corporation if more than a single block of stock of the foreign corporation is transferred in the section 361 exchange.

(12) *Section 1248 shareholder* is a domestic corporation that satisfies the ownership requirements of section 1248(a)(2) with respect to a foreign corporation, except that a domestic corporation, other than a domestic distributing corporation, that is a regulated investment company (as defined in section 851(a)), a real estate investment trust (as defined in section 856(a)), or an S corporation (as defined in section 1361(a)) cannot be a section 1248 shareholder.

(13) *Timely filed return* is a U.S. income tax return filed on or before the due date set forth in section 6072(b), including any extensions of time to file the return granted under section 6081.

(14) *Total section 1248(f) amount* is the sum of each section 1248(f) amount (as defined in paragraph (c)(10) of this section).

[T.D. 9614, 78 FR 17043, Mar. 19, 2013, as amended by T.D. 9760, 81 FR 15169, Mar. 22, 2016]

§ 1.1248(f)–2 Exceptions for certain distributions and attribution rules.

(a) *Section 337 stock distribution*—(1) *General exception*. In the case of a section 337 distribution (as defined in § 1.1248–1(b)(1)), § 1.1248(f)–1(b)(1) shall not apply to the distribution of stock of the foreign distributed corporation to the 80-percent distributee if the conditions of paragraphs (a)(1)(i), (a)(1)(ii) and (a)(1)(iii) of this section are satisfied.

(i) *80-percent distributee is a section 1248 shareholder*. Immediately after the section 337 distribution, the 80-percent distributee is a section 1248 shareholder

with respect to the foreign distributed corporation.

(ii) *Holding period*. The 80-percent distributee is treated as holding the stock of the foreign distributed corporation received in the section 337 distribution for the period during which the stock was held by the domestic distributing corporation.

(iii) *Basis*. The 80-percent distributee's basis in the stock of the foreign distributed corporation received in the section 337 distribution does not exceed the domestic distributing corporation's basis in such stock at the time of the section 337 distribution.

(2) *Elective exception*. If the conditions of paragraph (a)(1)(ii) or (a)(1)(iii) of this section are not otherwise satisfied, the domestic distributing corporation and the 80-percent distributee may elect to make adjustments to the 80-percent distributee's holding period or basis in the stock of the foreign distributed corporation, as appropriate, such that the conditions described in paragraphs (a)(1)(ii) and (iii) of this section are satisfied. The conditions and procedures for making the election are described in paragraph (a)(3) of this section. See paragraphs (a)(4) and (5) of this section for adjustments that are required as a result of making the election.

(3) *Election and reporting*—(i) *Statement required by domestic distributing corporation and 80-percent distributee*—(A) *In general*. The domestic distributing corporation and the 80-percent distributee make the election described in paragraph (a)(2) of this section by each including a statement, described in paragraph (a)(3)(i)(B) of this section, with a timely filed return for the taxable year during which the section 337 distribution occurs, and by entering into a written agreement described in paragraph (a)(3)(ii) of this section. If the domestic distributing corporation or the 80-percent distributee are members of a consolidated group at the time of the section 337 distribution but not the common parent, the common parent of the consolidated group makes the election on behalf of the domestic distributing corporation or the 80-percent distributee. The election described in paragraph (a)(2) of this section and made pursuant to this paragraph (a)(3) is irrevocable.

(B) *Form and content*. The statement of election must be entitled, ''STATEMENT TO ELECT TO APPLY EXCEPTION UNDER § 1.1248(f)–2(a)(2),'' state that the domestic distributing corporation and the 80-percent distributee have entered into a written agreement described in paragraph (a)(3)(ii) of this section, set forth the date of the agreement and the names of the parties to the agreement, and the adjustments to the 80-percent distributee's holding period and/or basis determined under section 334 in the stock of the foreign distributed corporation received in the section 337 distribution required under paragraphs (a)(4) and (a)(5) of this section.

(ii) *Written agreement*. The domestic distributing corporation and the 80-percent distributee must enter into a written agreement described in this paragraph (a)(3)(ii) on or before the due date (including extensions) of the domestic distributing corporation's U.S. income tax return for the taxable year during which the section 337 distribution occurs. Both the domestic distributing corporation and the 80-percent distributee must retain the original or a copy of the agreement as part of its records in the manner specified by § 1.6001–1(e). Both the domestic distributing corporation and the 80-percent distributee must provide a copy of the agreement to the Internal Revenue Service within 30 days of the receipt of a request for the agreement in connection with an examination of the taxable year during which the section 337 distribution occurs. The written agreement must—

(A) State the document is an agreement under paragraph (a)(3)(ii) of this section;

(B) Provide the name and taxpayer identification number (if any) of the domestic distributing corporation, the 80-percent distribute, and the foreign distributed corporation;

(C) With respect to the 80-percent distributee, state the holding period in the stock of the foreign distributed corporation received in the section 337 distribution as adjusted under paragraph (a)(4) of this section; and

(D) With respect to the 80-percent distributee, identify the basis as determined under section 334 of the stock of the foreign distributed corporation received in the section 337 distribution and the adjustment (if any) to such basis under paragraph (a)(5) of this section.

(4) *Holding period adjustment.* For purposes of section 1248, immediately after the section 337 distribution, the 80-percent distributee's holding period in the stock of the foreign distributed corporation received in the section 337 distribution shall equal the domestic distributing corporation's holding period in such stock at the time of the section 337 distribution.

(5) *Basis adjustments.* If the domestic distributing corporation's section 1248 amount with respect to the stock of the foreign distributed corporation received by the 80-percent distributee in the section 337 distribution exceeds the 80-percent distributee's postdistribution amount with respect to such stock (excess amount), the 80-percent distributee's basis as determined under section 334 in such stock shall be reduced by the excess amount.

(b) *Existing stock distribution under sections 355 or 361.* In the case of an existing stock distribution (as defined in § 1.1248(f)–1(b)(2)), § 1.1248(f)–1(b)(2) shall not apply to the distribution of stock of the foreign distributed corporation to a distributee that is a section 1248 shareholder with respect to the foreign distributed corporation immediately after the distribution if the domestic distributing corporation and all distributees that are section 1248 shareholders elect to apply the provisions of this paragraph (b) in accordance with paragraph (b)(1) of this section. See paragraphs (b)(2) and (3) of this section for adjustments that may be required if an election is made to apply the provisions of this paragraph (b).

(1) *Election and reporting*—(i) *Statement required by domestic distributing corporation and section 1248 shareholders*—(A) *In general.* The domestic distributing corporation and all distributees that are section 1248 shareholders elect to apply the provisions of paragraph (b) of this section by each including a statement, described in paragraph (b)(1)(i)(B) of this section, with a timely filed return for the taxable year during which the existing stock distribution occurs and by entering into a written agreement described in paragraph (b)(1)(ii) of this section. If the domestic distributing corporation or a section 1248 shareholder is a member of a consolidated group but not the common parent, the common parent of the consolidated group makes the election on behalf of the domestic distributing corporation or section 1248 shareholder. The election made under this paragraph (b)(1) is irrevocable.

(B) *Form and content.* The statement of election must be entitled, ''ELECTION TO APPLY EXCEPTION UNDER § 1.1248(f)–2(b),'' state that the domestic distributing corporation and all distributees that are section 1248 shareholders have entered into a written agreement described in paragraph (b)(1)(ii) of this section, the date of the agreement and the names of the parties to the agreement, and set forth any required adjustment to each section 1248 shareholder's holding period or section 358 basis (if any) in the stock of the foreign distributed corporation received in the existing stock distribution under paragraph (b)(2) or (b)(3) of this section, respectively.

(ii) *Written agreement.* The domestic distributing corporation and the section 1248 shareholders must enter into a written agreement described in this paragraph (b)(1)(ii) on or before the due date (including extensions) of the domestic distributing corporation's U.S. income tax return for the taxable year during which the existing stock distribution occurs. Each party to the agreement must retain the original or a copy of the agreement as part of its records in the manner specified by § 1.6001–1(e). Each party to the agreement must provide a copy of the agreement to the Internal Revenue Service within 30 days of the receipt of a request for the agreement in connection with an examination of the taxable year during which the existing stock distribution occurs. The written agreement must—

(A) State the document is an agreement under paragraph (b)(1)(ii) of this section;

(B) Provide the name and taxpayer identification number (if any) of the

domestic distributing corporation, the foreign distributed corporation, and each section 1248 shareholder;

(C) With respect to each section 1248 shareholder, state the holding period in the stock of the foreign distributed corporation received in the existing stock distribution as adjusted under paragraph (b)(2) of this section; and

(D) With respect to each section 1248 shareholder, identify the basis under section 358 of the stock of the foreign distributed corporation received in the existing stock distribution and the adjustment (if any) to the basis under paragraph (b)(3) of this section.

(2) *Holding period adjustments*. For purposes of section 1248, immediately after the existing stock distribution, each section 1248 shareholder's holding period in each share of stock of the foreign distributed corporation received in the existing stock distribution will be equal to the domestic distributing corporation's holding period in the share of stock at the time of the existing stock distribution.

(3) *Basis adjustments*. If the domestic distributing corporation's section 1248 amount with respect to a share of stock of the foreign distributed corporation received by a section 1248 shareholder in the existing stock distribution exceeds the section 1248 shareholder's postdistribution amount with respect to the share of stock (excess amount), the section 1248 shareholder's section 358 basis in the share of stock is reduced by the excess amount. For an illustration of the rule in this paragraph (b)(3), see paragraph (e) of this section, *Example 1* and *Example 3*.

(c) *New stock distribution under section 361*. In the case of a new stock distribution (as defined in §1.1248(f)–1(b)(3)), the amount that the domestic distributing corporation is required to include in gross income as a dividend under §1.1248(f)–1(b)(3) (total section 1248(f) amount) is reduced by the sum of the portions of any section 1248(f) amount attributable under paragraph (d) of this section to stock of the foreign distributed corporation distributed to distributees that are section 1248 shareholders, but only if the domestic distributing corporation and all the distributees that are section 1248 shareholders elect to apply the provisions of this paragraph (c) in accordance with paragraph (c)(1) of this section. See paragraphs (c)(2), (c)(3), and (c)(4) of this section for adjustments or income inclusions that are required if an election is made to apply the provisions of this paragraph (c). The adjustments or income inclusions provided in paragraphs (c)(2), (c)(3), and (c)(4) of this section apply after any adjustments required under section 367(a)(5) and §1.367(a)–7(c). For illustrations of this exception, see paragraph (e) of this section, *Example 2* and *Example 3* and §1.367(a)–3(e)(8), *Example 3*.

(1) *Election and reporting*—(i) *Statement required by domestic distributing corporation and section 1248 shareholders*—(A) *In general*. The domestic distributing corporation and all distributees that are section 1248 shareholders elect to apply the provisions of paragraph (c) of this section by each including a statement, in the form and containing the information listed in paragraph (c)(1)(i)(B) of this section, with a timely filed return for the taxable year during which the new stock distribution occurs and by entering into a written agreement described in paragraph (c)(1)(ii) of this section. If the domestic distributing corporation or a section 1248 shareholder is a member of a consolidated group at the time of the new stock distribution but is not the common parent, the common parent of the consolidated group makes the election on behalf of the domestic distributing corporation or section 1248 shareholder. The election made under this paragraph (c)(1) is irrevocable.

(B) *Form and content*. The statement of election must be entitled, ''ELECTION TO APPLY EXCEPTION UNDER §1.1248(f)–2(c),'' state that the domestic distributing corporation and each distributee that is a section 1248 shareholder have entered into a written agreement described in paragraph (c)(1)(ii) of this section, the date of the agreement and the names of the parties to the agreement, and describe, with respect to each section 1248 shareholder, the extent to which the shares of stock of the foreign distributed corporation received in the new stock distribution are divided into portions under paragraph (c)(2) of this section,

any adjustments to the section 358 basis of the stock under paragraph (c)(3) of this section, and the amount the domestic distributing corporation must include in gross income as a dividend under paragraph (c)(3) of this section.

(ii) *Written agreement*. The domestic distributing corporation and all distributees that are section 1248 shareholders must enter into a written agreement described in this paragraph (c)(1)(ii) on or before the due date (including extensions) of the domestic distributing corporation's U.S. income tax return for the taxable year during which the new stock distribution occurs. Each party to the agreement must retain the original or a copy of the agreement as part of its records in the manner specified by §1.6001–1(e). Each party to the agreement must provide a copy of the agreement to the Internal Revenue Service within 30 days of the receipt of a request for the agreement in connection with an examination of the taxable year during which the new stock distribution occurs. The written agreement must—

(A) State the document is an agreement under paragraph (c)(1)(ii) of this section;

(B) Provide the name and taxpayer identification number (if any) of the domestic distributing corporation, the foreign distributed corporation, and each section 1248 shareholder;

(C) With respect to each section 1248 shareholder, describe the extent to which the shares of stock of the foreign distributed corporation are divided into portions under paragraph (c)(2) of this section;

(D) With respect to each section 1248 shareholder, state the amount of earnings and profits attributable to the stock (or each block of stock, as applicable) of each foreign corporation transferred in the section 361 exchange that is attributable under §1.1248–8(b)(2)(iv) to the stock of the foreign distributed corporation received in the new stock distribution;

(E) With respect to each section 1248 shareholder, state the amount of the section 1248(f) amount with respect to the stock (or each block of stock, as applicable) of each foreign corporation transferred in the section 361 exchange that is attributable under §1.1248(f)–2(d) to the stock of the foreign distributed corporation received in the new stock distribution;

(F) With respect to each section 1248 shareholder, state the amount of the adjustment to the section 358 basis of the stock of the foreign distributed corporation under paragraph (c)(3) of this section; and

(G) With respect to each section 1248 shareholder, state the amount the domestic distributing corporation must include in gross income as a dividend under paragraph (c)(3) of this section.

(2) *Portions*. If the domestic distributing corporation transfers property, other than a single block of stock of a foreign corporation with respect to which the domestic distributing corporation is a section 1248 shareholder immediately before the section 361 exchange, to the foreign distributed corporation in the section 361 exchange that precedes the new stock distribution, then each share of stock of the foreign distributed corporation received by a distributee that is a section 1248 shareholder must be divided into portions as follows:

(i) One portion attributable to all property transferred in the section 361 exchange, other than property that is stock of a foreign corporation with respect to which the domestic distributing corporation is a section 1248 shareholder immediately before the section 361 exchange; and

(ii) One portion attributable to each block of stock of each foreign corporation transferred in the section 361 exchange with respect to which the domestic distributing corporation is a section 1248 shareholder immediately before the section 361 exchange. For the determination of the earnings and profits attributable to the stock (or block of stock, as applicable) of each foreign corporation transferred in the section 361 exchange that are attributable to a portion of a share of stock of the foreign distributed corporation, see §1.1248–8(b)(2)(iv). For the determination of the section 1248(f) amount with respect to the stock (or block of stock, as applicable) of each foreign corporation transferred in the section 361 exchange that is attributable to a

portion of a share of stock of the foreign distributed corporation, see paragraph (d)(2) of this section.

(3) *Basis adjustments and income inclusions.* If the section 1248(f) amount attributable to a portion of a share of stock (or whole share, if no division is required) (as determined under paragraph (d) of this section) of the foreign distributed corporation received by a distributee that is a section 1248 shareholder in the new stock distribution exceeds the section 1248 shareholder's postdistribution amount in the portion (or whole share, if no division is required) (excess amount), then the section 1248 shareholder's section 358 basis in the portion as determined under paragraph (c)(4) of this section (or whole share, if no division is required), as adjusted under § 1.367(a)–7(c)(3), is reduced by the excess amount, but not below zero. To the extent the excess amount exceeds the section 358 basis in the portion (or whole share, if no division is required), the domestic distributing corporation must include that portion of the section 1248(f) amount attributable to the portion of the share (or whole share, if no division is required) in gross income as a dividend. For an illustration of this rule, see paragraph (e) of this section, *Example 2*, and § 1.367(a)–3(e)(8), *Example 3*.

(4) *Divided shares of stock*—(i) *Basis.* The basis of a portion of a share of stock of the foreign distributed corporation created under paragraph (c)(2) of this section is the product of the section 1248 shareholder's section 358 basis, as adjusted under § 1.367(a)–7(c)(3), in the share of stock multiplied by the ratio of the basis determined under section 362 (taking into account any gain or deemed dividends recognized under section 367) of the property (section 362 basis) to which the portion relates, to the aggregate section 362 basis of all property received by the foreign distributed corporation in the section 361 exchange. For illustrations of this rule, see paragraph (e) of this section, *Example 2*, and § 1.367(a)–3(e)(8), *Example 3*.

(ii) *Fair market value.* The fair market value of a portion of a share of stock of the foreign distributed corporation created under paragraph (c)(2) of this section is the product of the fair market value of the share of stock multiplied by the ratio of the fair market value of the property to which the portion relates to the aggregate fair market value of all property received by the foreign distributed corporation in the section 361 exchange. For illustrations of this rule, see paragraph (e) of this section, *Example 2*, and § 1.367(a)–3(e)(8), *Example 3*.

(iii) *Subsequent exchanges.* For purposes of determining the gain realized on the sale or exchange of a share of stock of the foreign distributed corporation that has divided portions under paragraph (c)(2) of this section, the amount realized on the sale or exchange of the share will be allocated to each divided portion based on the relative fair market value of the property to which the portion relates as determined at the time of the reorganization.

(iv) *Duration of divided shares.* Shares of stock of the foreign distributed corporation that are divided into portions under paragraph (c)(2) of this section must be divided so long as section 1248(a) would apply to a sale or exchange of the shares.

(d) *Attribution of all or a portion of section 1248(f) amount to certain stock of the foreign distributed corporation.* This paragraph (d) applies if there is a new stock distribution for which an election under § 1.1248(f)–2(c)(1) is made. This paragraph (d) provides rules for attributing all or a portion, as applicable, of the section 1248(f) amount with respect to the stock of each foreign corporation transferred in the section 361 exchange by the domestic distributing corporation to shares of stock, or to portions of shares of stock, as applicable, received in the foreign distributed corporation and distributed to one or more distributees that are section 1248 shareholders with respect to the foreign distributed corporation. Paragraph (d)(1) of this section provides rules to attribute the applicable section 1248(f) amount among shares of stock of the foreign distributed corporation received by one or more distributees that are section 1248 shareholders. If shares of stock are divided into portions under paragraph (c)(2) of this section, paragraph (d)(2) of this

section provides additional rules to attribute the applicable section 1248 amount to portions of shares of stock received by one or more distributees that are section 1248 shareholders.

(1) *Attribution of all or a portion of section 1248(f) amount among shares of stock*. With respect to one or more shares of stock of the foreign distributed corporation distributed to a distributee that is a section 1248 shareholder, the portion of the section 1248(f) amount with respect to the stock of the foreign corporation transferred in the section 361 exchange that is equal to the distributee's hypothetical section 1248 amount is attributed among those shares of stock of the foreign distributed corporation based on the ratio of the value of a share distributed to the distributee to the value of all shares of stock distributed to the distributee (attributable share amount).

(2) *Attribution of all or a portion of section 1248(f) amount to portions of a share of stock*—(i) *Single block of stock*. If a single block of stock of the foreign corporation is transferred in the section 361 exchange, the attributable share amount (as determined under paragraph (d)(1) of this section) is attributed to the portion of the share that relates to the single block of stock of the foreign corporation.

(ii) *Multiple blocks of stock*. If multiple blocks of stock of the foreign corporation are transferred in the section 361 exchange, the attributable share amount (as determined under paragraph (d)(1) of the section) is attributed among the portions of the share that relate to such multiple blocks of stock of the foreign corporation. The portion of the attributable share amount that is attributable to a portion to which a block of stock relates is that amount that bears the same ratio that the section 1248(f) block amount with respect to that block of stock bears to the section 1248(f) amount with respect to the stock of the foreign corporation.

(e) *Examples*. The rules of this section are illustrated by the following examples. See also §1.367(a)–3(e)(8), *Example 3*. For purposes of the examples, unless otherwise indicated: DP and DC are domestic corporations; X is a United States citizen; FP is a foreign corporation; CFC1, CFC2, and FA are controlled foreign corporations; each corporation has a single class of stock outstanding and uses the calendar year as its taxable year; each shareholder of a corporation owns a single block of stock in the corporation; DC owns Business A, which consists solely of property whose fair market value exceeds its basis and could satisfy the requirements of the active foreign trade or business exception under section 367(a)(3) and §1.367(a)–2; DC owns no other assets and has no liabilities; the requirements in §1.367(a)–7(c)(5) are satisfied; no earnings and profits of a foreign corporation are described in section 1248(d); and none of the foreign corporations in the examples is a surrogate foreign corporation (within the meaning of section 7874) as a result of the transactions described in the examples because one or more of the conditions of section 7874(a)(2)(B) is not satisfied.

Example 1. Existing stock distribution under section 355(c)(1); gain recognition and adjustment to stock basis. (i) *Facts*. DP, FP, and X own 80%, 10%, and 10%, respectively, of the outstanding stock of DC. DP's DC stock has a $140x basis, $160x fair market value, and a 2-year holding period. DC wholly owns CFC1. DC's CFC1 stock has a $50x basis, $100x fair market value (therefore a gain of $50x), $25x of earnings and profits attributable to it for purposes of section 1248, and a $25x section 1248 amount (computed as the lesser of $50x gain in the CFC1 stock and $25x of section 1248 earnings and profits), and a 3-year holding period. On December 31, year 3, DC distributes all of the CFC1 stock to DP, FP, and X on a pro-rata basis in a distribution to which section 355 applies. The fair market value of the CFC1 stock received by DP, FP, and X is $80x, $10x, and $10x, respectively. After the distribution, DP's stock in DC has a fair market value of $80x and DP's section 358 basis in the CFC1 stock is $70x (a pro rata portion, or 50%, of DP's $140x basis in the DC stock immediately before the distribution). See §1.358–2(a)(iv).

(ii) *Result*. (A) Under §1.367(e)–1(b)(1), DC must recognize $5x gain on the distribution of CFC1 stock to FP (10% of the $50x gain in the CFC1 stock). Under §1.367(b)–5(b)(1)(ii), DC must also recognize $5x gain on the distribution of CFC1 stock to X (10% of the $50x gain in the CFC1 stock). Of the aggregate $10x gain recognized by DC, $5x is recharacterized as a dividend under section 1248(a), computed as 20% of the $25x section 1248 amount with respect to the CFC1 stock. See §1.1248–1 for additional consequences.

(B) DC's distribution of CFC1 stock to DP is described in section 1248(f)(1) and §1.1248(f)–1(b)(2) because the distribution is pursuant to section 355(c)(1) (an existing stock distribution). As a result, the general rule is that DC must include in gross income as a dividend the section 1248 amount with respect to the CFC1 stock distributed to DP, or $20x (computed as 80% of the $25x section 1248 amount). However, if DP and DC make the election under paragraph (b)(1) of this section, §1.1248(f)–1(b)(2) will not apply to DC's distribution of CFC1 stock to DP. If DP and DC make the election, then:

(*1*) Under paragraph (b)(2) of this section, for purposes of section 1248, immediately after the distribution DP will have a 3-year holding period in the CFC1 stock, the same holding period DC had in the CFC1 stock at the time of the distribution.

(*2*) Under paragraph (b)(3) of this section, DP's section 358 basis in the CFC1 stock ($70x) is reduced by $10x, the amount by which DC's section 1248 amount with respect to the CFC1 stock ($20x) distributed to DP exceeds DP's postdistribution amount with respect to the CFC1 stock ($10x). Under §1.1248(f)–1(c)(6), DP's postdistribution amount equals the amount that DP would include in gross income as a dividend under section 1248(a) if DP sold the CFC1 stock immediately after the distribution, or $10x, which is computed as the lesser of the $10x gain in the CFC1 stock ($80x fair market value, less $70x basis) and $20x of section 1248 earnings and profits attributable to the CFC1 stock, taking into account DP's 3-year holding period in the stock as required by paragraph (b)(2) of this section. As adjusted under paragraph (b)(3) of this section, DP's basis in the CFC1 stock is $60x ($70x basis, less $10x required basis reduction).

Example 2. New stock distribution under section 361(c)(1); adjustment to stock basis. (i) *Facts.* DP wholly owns DC. DP's DC stock has a $180x basis and $200x fair market value. DC wholly owns CFC1 and CFC2. DC's CFC1 stock has a $70x basis, $100x fair market value (therefore a gain of $30x), $40x of earnings and profits attributable to it for purposes of section 1248, and a section 1248 amount of $30x (computed as the lesser of the $30x gain in CFC1 stock and $40x section 1248 earnings and profits). DC's CFC2 stock has a $130x basis, $100x fair market value (therefore a loss of $30x), $80x of earnings and profits attributable to it for purposes of section 1248, and a section 1248 amount of $0x (computed as the lesser of the $0x gain and $80x section 1248 earnings and profits). On December 31, Year 1, in a reorganization described in section 368(a)(1)(F), DC transfers the CFC1 stock and the CFC2 stock to FA, a newly formed corporation, in exchange for 100 shares of FA stock. DC distributes the 100 shares of FA stock to DP. DC's transfer of the CFC1 stock and CFC2 stock to FA in exchange for FA stock qualifies as a section 361 exchange, and DC's distribution of the 100 shares of FA stock to DP is pursuant to section 361(c)(1). DP exchanges its DC stock for the 100 shares of FA stock pursuant to section 354. Immediately after the transaction, DP wholly owns FA. DP and DC elect to apply the provisions of §1.367(a)–7(c) in accordance with §1.367(a)–7(c)(5). Pursuant to §1.367(a)–3(e)(3)(iii)(A), DP properly files a gain recognition agreement with respect to the CFC1 stock that satisfies the conditions of §§1.367(a)–3(e)(6) and 1.367(a)–8.

(ii) *Result.* (A) DC does not recognize gain under §1.367(a)–3(e)(2) with respect to the transfer of the CFC1 stock to FA because the three conditions in §1.367(a)–3(e)(3)(i), (e)(3)(ii), and (e)(3)(iii) are satisfied. First, §1.367(a)–3(e)(3)(i) is satisfied because the requirements of §1.367(a)–7(c) are satisfied, including that an election is made to apply §1.367(a)–7(c). Second, the requirements under §1.367(a)–3(e)(3)(ii) related to transfers of domestic stock are not applicable because CFC1 is a foreign corporation. Third, because DC owns all the stock of FA immediately after DC's receipt of the FA stock in the section 361 exchange but prior to, and without taking into account, DC's distribution of the FA stock to DP, for purposes of satisfying the requirements of §1.367(a)–3(e)(3)(iii), DP properly files a gain recognition agreement with respect to the CFC1 stock that satisfies the conditions of §§1.367(a)–3(e)(6) and 1.367(a)–8. Furthermore, DC is not required to recognize gain under §1.367(a)–7(c)(2)(ii), and DP is not required to reduce its $180x section 358 basis in the FA stock under §1.367(a)–7(c)(3), because the inside gain (within the meaning of §1.367(a)–7(f)(5)) is $0x ($200x aggregate fair market value of CFC1 stock and CFC2 stock, less $200x aggregate basis of CFC1 stock and CFC2 stock). In addition, DC is not required to include in income as a deemed dividend the $30x section 1248 amount with respect to the CFC1 stock under §1.367(b)–4(b)(1)(i) because immediately after DC's receipt of the FA stock in the section 361 exchange but prior to, and without taking into account, DC's distribution of the FA stock to DP, CFC1 and FA are controlled foreign corporations as to which DC is a section 1248 shareholder. See §1.367(b)–4(b)(1)(ii)(A). With respect to the transfer of the CFC2 stock to FA, DC's section 1248 amount with respect to the CFC2 stock is $0x; therefore, §1.367(b)–4(b)(1)(i) has no application.

(B) Under §1.1248(f)–1(b)(3), as a result of the section 361(c)(1) distribution of the FA stock to DP (a new stock distribution), the general rule is that DC must include in gross income as a dividend the total section 1248(f) amount (defined in §1.1248(f)–1(c)(14)). The total section 1248(f) amount is $30x, the sum of the section 1248(f) amount (defined in §1.1248(f)–1(c)(10)) with respect to the CFC1

stock ($30x) and CFC2 stock ($0x). The section 1248(f) amount with respect to the CFC1 stock is the amount that DC would have included in income as a deemed dividend under §1.367(b)–4(b)(1)(i) with respect to the CFC1 stock if the requirements under §1.367(b)–4(b)(1)(ii)(A) had not been satisfied ($30x), less the amount of gain recognized by DC under §1.367(a)–7(c)(2) that is allocable to the CFC1 stock under §1.367(a)–7(e)(1) and treated as a dividend under section 1248(a) ($0x). Similarly, the section 1248(f) amount with respect to the CFC2 stock is the amount that DC would have included in income as a deemed dividend under §1.367(b)–4(b)(1)(i) with respect to the CFC2 stock if the requirements under §1.367(b)–4(b)(1)(ii)(A) had not been satisfied ($0x), less the amount of gain recognized by DC under §1.367(a)–7(c)(2) that is allocable to the CFC2 stock under §1.367(a)–7(e)(1) and treated as a dividend under section 1248(a) ($0x).

(C) If, however, DP and DC make the election provided in paragraph (c)(1) of this section, the amount that DC is required to include in gross income as a dividend under §1.1248(f)–1(b)(3) (the total section 1248(f) amount of $30x) is reduced to the extent the section 1248(f) amount with respect to the CFC1 stock ($30x) and CFC2 stock ($0x) is attributable under paragraph (d) of this section to the shares of FA stock distributed to one or more distributees that are section 1248 shareholders of FA. The only distributee is DP, and DP is a section 1248 shareholder with respect to FA. If DP and DC elect to apply paragraph (c) of this section, then:

(*1*) Under paragraph (d)(1) of this section, the portion of the section 1248(f) amount with respect to the CFC1 stock that is attributed to the shares of FA stock distributed to DP is equal to DP's hypothetical section 1248 amount (as defined in §1.1248(f)–1(c)(4)) with respect to the CFC1 stock. Because DP is the only shareholder of DC, DP's hypothetical section 1248 amount equals the section 1248(f) amount with respect to the CFC1 stock ($30x). The $30x hypothetical section 1248 amount is attributed pro rata (based on relative values) among the 100 shares of FA stock distributed to DP, and the attributable share amount (as defined in paragraph (d)(1) of this section) is $.30x. Paragraph (d)(1) of this section has no application with respect to the CFC2 stock because there is no section 1248(f) amount with respect to the CFC2 stock.

(*2*) If the shares of FA stock are divided into portions, the rules of paragraph (d)(2) of this section apply to attribute the attributable share amount ($.30x) to portions of shares of FA stock distributed to DP. Under paragraph (c)(2)(ii) of this section, the 100 shares of FA stock are divided into two portions, one portion related to the single block of CFC1 stock and one portion related to the single block of CFC2 stock. Under paragraph (d)(2)(i) of this section, the attributable share amount of $.30x is attributed to the portion of the 100 shares of FA stock that relates to the single block of CFC1 stock. Thus, all of the $30x section 1248(f) amount with respect to the CFC1 stock is attributable to the 100 shares of FA stock.

(*3*) Because the election under paragraph (c)(1) of this section is made, the total section 1248(f) amount ($30x) that DC is otherwise required to include in gross income as a dividend under §1.1248(f)–1(b)(3) is reduced by $30x, the portion of the section 1248(f) amount with respect to the CFC1 stock that is attributable under paragraph (d) of this section to the shares of FA stock distributed to DP. Thus, the amount DC is required to include in gross income as a dividend under §1.1248(f)–1(b)(3) is $0x ($30x less $30x).

(*4*) Under paragraph (c)(4)(i) of this section, the basis of each portion is the product of DP's section 358 basis in the share of FA stock multiplied by the ratio of the section 362 basis of the property (CFC1 stock or CFC2 stock, as applicable) to which the portion relates, to the aggregate section 362 basis of all property (CFC1 stock and CFC2 stock) received by FA in the section 361 exchange. Under paragraph (c)(4)(ii) of this section, the fair market value of each portion is the product of the fair market value of the share of FA stock multiplied by the ratio of the fair market value of the property (CFC1 stock or CFC2 stock, as applicable) to which the portion relates, to the aggregate fair market value of all property (CFC1 stock and CFC2 stock) received by FA in the section 361 exchange. The section 362 basis of the CFC1 stock and CFC2 stock is $70x and $130x, respectively, for a total section 362 basis of $200x. The CFC1 stock and CFC2 stock each has a fair market value of $100x, for a total fair market value of $200x. Therefore, the portions attributable to the CFC1 stock have an aggregate basis of $63x ($180x multiplied by $70x/$200x) and fair market value of $100x ($200x multiplied by $100x/$200x), resulting in aggregate gain in such portions of $37x (or $.37x per portion in each of the 100 shares). The portions attributable to the CFC2 stock have an aggregate basis of $117x ($180x multiplied by $130x/$200x) and fair market value of $100x ($200x multiplied by $100x/$200x), resulting in aggregate losses in such portions of $17x (or $.17x per portion in each of the 100 shares).

(*5*) Under §1.1248–8(b)(2)(iv), the $40x earnings and profits attributable to the single block of CFC1 stock are attributed to the portions of the 100 shares of FA stock that relate to the CFC1 stock. Similarly, the $80x of earnings and profits attributable to the single block of CFC2 stock are attributed to the portions of the 100 shares of the FA stock that relate to the CFC2 stock. Thus, DP's postdistribution amount (defined in §1.1248(f)–1(c)(6)) with respect to the portions

of the shares of FA attributable to the CFC1 stock is $37x, the lesser of the aggregate gain in the portions attributable to the CFC1 stock of $37x (computed in paragraph (ii)(C)(*4*) of this *Example 2*) and the $40x earnings and profits attributable to such portions. Furthermore, DP's postdistribution amount with respect to the portions of the shares of FA attributable to the CFC2 stock is $0x, the lesser of the aggregate gain in the portions attributable to the CFC2 stock of $0x (computed in paragraph (ii)(C)(*4*) of this *Example 2* to be an aggregate loss of $17x) and the $80x earnings and profits attributable to such portions.

(*6*) Under paragraph (c)(3) of this section, DP's section 358 basis in the portions of the 100 shares of FA stock attributable to the CFC1 stock ($63x, computed in paragraph (ii)(C)(*4*) of this *Example 2*) is reduced by the amount (if any) by which the section 1248(f) amount attributable to such portions under paragraph (d) of this section ($30x, as computed in paragraph (ii)(C)(*2*) of this *Example 2*) exceeds DP's postdistribution amount with respect to such portions ($37x, computed in paragraph (ii)(C)(*5*) of this *Example 2*). Thus, there is no basis reduction in the portions of the 100 shares of FA stock attributable to the CFC1 stock. DP's section 358 basis in the portions of the 100 shares of FA stock attributable to the CFC2 stock is not reduced because the section 1248(f) amount attributable to such portions under paragraph (d) of this section is $0x (computed in paragraph (ii)(C)(*2*) of this *Example 2*), which equals DP's postdistribution amount with respect to such portions of $0x (as computed in paragraph (ii)(C)(*5*) of this *Example 2*).

Example 3. Combined existing stock distribution and new stock distribution under sections 355(c)(1) and 361(c)(1). (i) *Facts.* DP owns all 100 outstanding shares of stock of DC. DP's DC stock has a $180x basis (each of the 100 shares having a basis of $18), $200x fair market value, and 2-year holding period. DC owns all 60 shares of the outstanding stock of CFC1; all such shares constitute a single block of stock. DC's CFC1 stock has a $50x basis, $60x fair market value, $30x of earnings and profits attributable to it for purposes of section 1248, a $10x section 1248 amount (computed as the lesser of $10x gain and $30x of section 1248 earnings and profits), and a 3-year holding period. DC also owns all 40 shares of the outstanding stock of CFC2; all such shares constitute a single block of stock. DC's CFC2 stock has a $30x basis, $40x fair market value, $20x of earnings and profits attributable to it for purposes of section 1248, and a $10x section 1248 amount (computed as the lesser of $10x gain and $20x of section 1248 earnings and profits). DC also owns Business A, which has a fair market value of $100x. On December 31, year 4, in a divisive reorganization described in section 368(a)(1)(D), DC transfers the CFC2 stock to CFC1 in exchange for 40 shares of newly issued CFC1 stock. DC's transfer of the CFC2 stock to CFC1 qualifies as a section 361 exchange. DC then distributes the 100 shares of CFC1 stock (60 shares held prior to the transaction and 40 shares received in the section 361 exchange) to DP in a transaction that qualifies under section 355. DP properly files a gain recognition agreement with respect to the CFC2 stock that satisfies the conditions of §§1.367(a)–3(e)(6) and 1.367(a)–8. DP and DC properly make the elections provided in §1.367(a)–7(c)(5) and paragraphs (b) and (c) of this section.

(ii) *Result.* (A) DC does not recognize gain under §1.367(a)–3(e)(2) with respect to the transfer of the CFC2 stock to CFC1 because the three conditions in §1.367(a)–3(e)(3)(i), (e)(3)(ii), and (e)(3)(iii) are satisfied. First, §1.367(a)–3(e)(3)(i) is satisfied because the requirements of §1.367(a)–7(c) are satisfied, including that an election is made to apply §1.367(a)–7(c). Second, the requirements under §1.367(a)–3(e)(3)(ii) related to transfers of domestic stock are not applicable because CFC2 is a foreign corporation. Third, because DC and DP own all the stock of CFC1 for purposes of satisfying the requirements of §1.367(a)–3(e)(3)(iii), DP properly files a gain recognition agreement with respect to the CFC2 stock that satisfies the conditions of §§1.367(a)–3(e)(6) and 1.367(a)–8. See paragraph (ii)(G) of this example for the computation of the amount of gain subject to the gain recognition agreement. In addition, DC is not required to include in income as a dividend the $10x section 1248 amount with respect to the CFC2 stock under §1.367(b)–4(b)(1)(i) because immediately after DC's receipt of the CFC1 stock in the section 361 exchange but prior to, and without taking into account, DC's distribution of the CFC1 stock to DP, CFC1 and CFC2 are controlled foreign corporations as to which DC is a section 1248 shareholder. See §1.367(b)–4(b)(1)(ii)(A).

(B) DC is not required to recognize gain under §1.367(a)–7(c)(2)(i) because DP, a control group member (as defined in §1.367(a)–7(f)(1)), owns 100% of DC. DC is not required to recognize gain under §1.367(a)–7(c)(2)(ii) because the amount described in §1.367(a)–7(c)(2)(ii)(A) ($10x) does not exceed the amount described in §1.367(a)–7(c)(2)(ii)(B) ($40x). The $10x described in §1.367(a)–7(c)(2)(ii)(A) equals the product of the inside gain (as defined in §1.367(a)–7(f)) ($10x) multiplied by DP's ownership interest percentage (as defined in §1.367(a)–7(f)) (100%), reduced by the sum of the amounts in §1.367(a)–7(c)(2)(ii)(A)(*1*), (c)(2)(ii)(A)(*2*), and (c)(2)(ii)(A)(*3*) ($0x). Under §1.367(a)–7(f)(5), the $10x of inside gain is the amount by which the aggregate fair market value of the section 367(a) property (CFC2 stock with a fair market value of $40x) exceeds the sum of the inside basis ($30x) of such property, and

$0x (the product of the section 367(a) percentage (100%) multiplied by DC's deductible liabilities assumed by CFC1 ($0x)). Under § 1.367(a)–7(f)(4), the $30x inside basis equals the aggregate basis of the section 367(a) property transferred in the section 361 exchange ($30x), increased by any gain or deemed dividends recognized by DC with respect to the section 367(a) property under section 367 ($0x). The $40x described in § 1.367(a)–7(c)(2)(ii)(B) is the product of the section 367(a) percentage (100%) multiplied by the fair market value of the 40 shares of CFC1 stock received by DC in the section 361 exchange and distributed to DP ($40x).

(C) Under section 358, DP must allocate the $180x basis in its 100 shares of DC stock between the 100 shares of DC stock (fair market value of $100x) and the 100 shares of CFC1 stock (fair market value of $100x) held after the distribution based on the relative fair market values of the shares. Accordingly, after the allocation of the basis under section 358, but prior to the application of § 1.367(a)–7(c)(3), the basis of DP's DC stock is $90x and the basis of DP's CFC1 stock is $90x. With respect to the $90x basis in the 100 shares of CFC1 stock, $36x is attributable to the 40 shares of CFC1 stock received by DC in the section 361 exchange ($90x multiplied by 40/100), and $54x is attributable to the 60 shares of CFC1 stock owned by DC prior to the section 361 exchange ($90x multiplied by 60/100). See § 1.358–2(a)(2)(iv).

(D) Pursuant to § 1.367(a)–7(c)(3)(ii), any adjustment to DP's basis in the CFC1 stock required under § 1.367(a)–7(c)(3)(i) can only be made with respect to the 40 shares of CFC1 stock received by DC in the section 361 exchange. Under § 1.367(a)–7(c)(3)(i)(A), DP must reduce its section 358 basis ($36x) in the 40 shares of CFC1 stock by $6x, the amount by which DP's attributable inside gain ($10x), reduced by the sum of the amounts in § 1.367(a)–7(c)(2)(ii)(A)(*1*), (c)(2)(ii)(A)(*2*), and (c)(2)(ii)(A)(*3*) ($0x) (as computed in paragraph (ii)(B) of this *Example 3*) exceeds DP's outside gain (as defined in § 1.367(a)–7(f)) ($4x). DP's $4x outside gain equals the product of the section 367(a) percentage (as defined in § 1.367(a)–7(f)) (100%) multiplied by the amount by which the fair market value ($40x) of the 40 shares of CFC1 stock is greater than DP's section 358 basis in the stock ($36x). After the $6x reduction to stock basis required under § 1.367(a)–7(c)(3), but before the application of § 1.1248(f)–2(c)(3), DP's basis in the 40 shares of CFC1 stock is $30x.

(E) DC's distribution of the 40 shares of newly issued CFC1 stock is subject to § 1.1248(f)–1(b)(3) (a new stock distribution). Except as provided in § 1.1248(f)–2(c), under § 1.1248(f)–1(b)(3) DC must include in gross income as a dividend the total section 1248(f) amount (as defined in § 1.1248(f)–1(c)(14)). The total section 1248(f) amount is $10x, the sum of the section 1248(f) amount (as defined in § 1.1248(f)–1(c)(10)) with respect to the stock of each foreign corporation transferred in the section 361 exchange. Only the CFC2 stock is transferred in the section 361 exchange; therefore, the total section 1248(f) amount is equal to the section 1248(f) amount with respect to the CFC2 stock ($10x). The $10x section 1248(f) amount with respect to the CFC2 stock is the amount that DC would have included in income as a deemed dividend under § 1.367(b)–4(b)(1)(i) with respect to the CFC2 stock if the requirements of § 1.367(b)–4(b)(1)(ii)(A) had not been satisfied ($10x), reduced by the amount of gain recognized by DC under § 1.367(a)–7(c)(2) allocable to the CFC2 stock and treated as a dividend under section 1248(a) (in this case, $0x, as described in paragraph (ii)(B) of this *Example 3*).

(F) However, because DC and DP (a section 1248 shareholder of CFC1 immediately after the distribution) elect to apply the provisions of § 1.1248(f)–2(c) (as provided in § 1.1248(f)–2(c)(1)), the amount that DC is required to include in income as a dividend under § 1.1248(f)–1(b)(3) ($10x total section 1248(f) amount as computed in paragraph (ii)(E) of this *Example 3*) is reduced by the sum of the portions of the section 1248(f) amount with respect to the CFC2 stock that is attributable (under the rules of § 1.1248(f)–2(d)) to the 40 shares of CFC1 stock distributed to DP. As stated in the facts, the election is made to apply § 1.1248(f)–2(c).

(*1*) Under paragraph (d)(1) of this section, the portion of the section 1248(f) amount with respect to the CFC2 stock that is attributed to the 40 shares of CFC1 stock distributed to DP is equal to DP's hypothetical section 1248 amount (as defined in § 1.1248(f)–1(c)(4)) with respect to the CFC2 stock. Because DP is the only shareholder of DC, DP's hypothetical section 1248 amount equals the section 1248(f) amount with respect to the CFC2 stock ($10x). The $10x hypothetical section 1248 amount is attributed pro rata (based on relative values) among the 40 shares of CFC1 stock distributed to DP, and the attributable share amount (as defined in paragraph (d)(1) of this section) is $.25x.

(*2*) The 40 shares of CFC1 stock are not divided into portions under paragraph (c)(2) of this section because the only property transferred by DC to CFC1 is a single block of stock of CFC2. If the 40 shares of CFC1 stock were required to be divided into portions, however, the rules of paragraph (d)(2) of this section apply to attribute the attributable share amount ($.25x) to portions of shares of CFC1 stock distributed to DP.

(*3*) Because the election under paragraph (c)(1) of this section is made, the total section 1248(f) amount ($10x) that DC is otherwise required to include in gross income as a dividend under § 1.1248(f)–1(b)(3) is reduced by $10x, the portion of the section 1248(f) amount with respect to the CFC2 stock that

is attributable under paragraph (d) of this section to the 40 shares of CFC1 stock distributed to DP. Thus, the amount DC is required to include in gross income as a dividend under § 1.1248(f)–1(b)(3) is $0x ($30x less $30x).

(*4*) Under § 1.1248–8(b)(2)(iv), the $20x earnings and profits attributable to the single block of CFC2 stock are attributed pro rata to the 40 shares of CFC1 stock. Thus, DP's postdistribution amount (defined in § 1.1248(f)–1(c)(6)) with respect to the 40 shares of CFC1 stock attributable to the CFC2 stock is $10x, the lesser of the aggregate gain in the 40 shares of CFC1 stock of $10x ($40x fair market value, less $30x section 358 basis, as described in paragraph (ii)(D) of this *Example 3*) and the $20x earnings and profits attributable to such shares.

(*5*) Under paragraph (c)(3) of this section, DP's section 358 basis in the 40 shares of CFC1 stock ($30x) is reduced by the amount (if any) by which the section 1248(f) amount attributable to such shares under paragraph (d) of this section ($10x, as computed in paragraph (ii)(E) of this *Example 3*) exceeds DP's postdistribution amount with respect to such shares ($10x). Thus, there is no basis reduction in the 40 shares of CFC1 stock.

(G) Pursuant § 1.367(a)–3(e)(6), the amount of gain subject to the gain recognition agreement entered into by DP with respect to the CFC2 stock is $10x, which is the product of DP's ownership interest percentage (100%) multiplied by the gain realized by DC in the 361 exchange prior to taking into account the application of any other provision of section 367 ($10x), reduced by the sum of the amounts described in § 1.367(a)–3(e)(6)(i)(A), (e)(6)(i)(B), (e)(6)(i)(C), and (e)(6)(i)(D) ($0x).

(H) DC's distribution of the 60 shares of CFC1 stock it held before the section 361 exchange is subject to § 1.1248(f)–1(b)(2) (an existing stock distribution); however, because DC and DP make the election provided in paragraph (b)(1) of this section, § 1.1248(f)–1(b)(2) does not apply to the distribution.

(*1*) Under paragraph (b)(2) of this section, for purposes of section 1248, DP will have a 3-year holding period in the 60 shares of CFC1 stock received, the same holding period that DC had in the 60 shares of CFC1 stock.

(*2*) Under paragraph (b)(3) of this section, DP's section 358 basis in the 60 shares of CFC1 stock received ($54x, as computed in paragraph (ii)(C) of this *Example 3*) is reduced by $4x, the amount by which DC's section 1248 amount ($10x) with respect to the 60 shares of CFC1 stock exceeds DP's postdistribution amount ($6x) with respect to the 60 shares of CFC1 stock. Under § 1.1248(f)–1(c)(6), DP's postdistribution amount with respect to the 60 shares of CFC1 stock equals the amount that DP would include in gross income as a dividend under section 1248(a) if DP sold the 60 shares of CFC1 stock immediately after the distribution, or $6x, which is computed as the lesser of the $6x gain in the such shares of CFC1 stock ($60x fair market value, less $54x basis) and $30x of section 1248 earnings and profits attributable to the CFC1 stock, taking into account DP's 3-year holding period in the stock as required by paragraph (b)(2) of this section. As adjusted under paragraph (b)(3) of this section, DP's basis in the 60 shares of CFC1 stock is $50x ($54x basis, less $4x basis reduction).

(f) *Applicable cross-references*. For rules relating to the attribution of earnings and profits to the stock of a foreign corporation following certain nonrecognition transactions, see § 1.1248–8. For rules relating to a transfer of property by a domestic corporation to a foreign corporation in a section 361 exchange that precedes a new stock distribution, see § 1.367(a)–7. If the property transferred includes stock of a corporation, see also §§ 1.367(a)–3(e) and 1.367(b)–4. For other rules that may apply if a domestic corporation distributes the stock of a foreign corporation in a new stock distribution or an existing stock distribution satisfying the requirements of section 355, see §§ 1.367(b)–5(b)(1) and 1.367(e)–1.

[T.D. 9614, 78 FR 17044, Mar. 19, 2013, as amended by T.D. 9760, 81 FR 15169, Mar. 22, 2016; T.D. 9803, 81 FR 91031, Dec. 16, 2016]

§ 1.1248(f)–3 Reasonable cause and effective/applicability dates.

(a) *Reasonable cause for failure to comply*—(1) *Request for relief*. If an 80-percent distributee, a distributee that is a section 1248 shareholder, or the domestic distributing corporation (reporting person) fails to timely comply with any requirement under § 1.1248(f)–2, the failure shall be deemed not to have occurred if the reporting person is able to demonstrate that the failure was due to reasonable cause and not willful neglect using the procedure set forth in paragraph (a)(2) of this section. Whether the failure to timely comply was due to reasonable cause and not willful neglect will be determined by the Director of Field Operations, Cross Border Activities Practice Area of Large Business & International (Director) based on all the facts and circumstances.

(2) *Procedures for establishing that a failure to timely comply was due to reasonable cause and not willful neglect*—(i) *Time of submission*. A reporting person's

statement that the failure to timely comply was due to reasonable cause and not willful neglect will be considered only if, promptly after the reporting person becomes aware of the failure, an amended return is filed for the taxable year to which the failure relates that includes the information that should have been included with the original return for such taxable year or that otherwise complies with the rules of this section, and that includes a written statement explaining the reasons for the failure to timely comply.

(ii) *Notice requirement*. In addition to the requirements of paragraph (a)(2)(i) of this section, the reporting person must comply with the notice requirements of this paragraph (a)(2)(ii). If any taxable year of the reporting person is under examination when the amended return is filed, a copy of the amended return and any information required to be included with such return must be delivered to the Internal Revenue Service personnel conducting the examination. If no taxable year of the reporting person is under examination when the amended return is filed, a copy of the amended return and any information required to be included with such return must be delivered to the Director.

(b) *Effective/applicability date*—(1) *General rule*. Except as provided in paragraph (b)(2)(ii) of this section, §§ 1.1248(f)–1 and 1.1248(f)–2 apply to distributions occurring on or after April 18, 2013. The provisions of § 1.1248(f)–3(a) apply to distributions occurring on or after April 17, 2013.

(2) *Transactions described in Notice 87–64*—(i) *Gain not otherwise recognized*. For distributions occurring on or after September 21, 1987, and before April 18, 2013, section 1248(f)(1) shall not apply to the extent the domestic distributing corporation recognizes gain with respect to the stock of the foreign distributed corporation as a result of the distribution under another provision of subtitle A of the Internal Revenue Code.

(ii) *Section 355 distributions*. Taxpayers may apply the provisions of § 1.1248(f)–2(b) to distributions occurring on or after September 21, 1987.

[T.D. 9614, 78 FR 17050, Mar. 19, 2013, as amended by T.D. 9760, 81 FR 15169, Mar. 22, 2016]

§ 1.1249–1 Gain from certain sales or exchanges of patents, etc., to foreign corporations.

(a) *General rule*. Section 1249 provides that if gain is recognized from the sale or exchange after December 31, 1962, of a patent, an invention, model, or design (whether or not patented), a copyright, a secret formula or process, or any other similar property right (not including property such as goodwill, a trademark, or a trade brand) to any foreign corporation by any United States person (as defined in section 7701(a)(30)) which controls such foreign corporation, and if such gain would (but for the provisions of section 1249) be gain from the sale or exchange of a capital asset or of property described in section 1231, then such gain shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. Section 1249 applies only to gain recognized in taxable years beginning after December 31, 1962.

(b) *Control*. For purposes of paragraph (a) of this section, the term *control* means, with respect to any foreign corporation, the ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. For purposes of the preceding sentence, the rules for determining ownership of stock provided by section 958 (a) and (b), and the principles for determining percentage of total combined voting power owned by United States shareholders provided by paragraphs (b) and (c) of § 1.957–1, shall apply.

[T.D. 6765, 29 FR 14879, Nov. 3, 1964]

§ 1.1250–1 Gain from dispositions of certain depreciable realty.

(a) *Dispositions after December 31, 1969*—(1) *Ordinary income*. (i) In general, section 1250(a)(1) provides that, upon a disposition of an item of section 1250 property after December 31, 1969, the applicable percentage of the lower of:

(*a*) The additional depreciation (as defined in § 1.1250–2) attributable to periods after December 31, 1969 in respect of the property, or

(*b*) The excess of the amount realized on a sale, exchange, or involuntary conversion (or the fair market value of the property on any other disposition) over the adjusted basis of the property,

Shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income). The amount of such gain shall be determined separately for each item (see subparagraph (2)(ii) of this paragraph) of section 1250 property. If the amount determined under (*b*) of this subdivision exceeds the amount determined under (*a*) of this subdivision, then such excess shall be treated as provided in subdivision (ii) of this subparagraph. For relation of section 1250 to other provisions, see paragraph (c) of this section.

(ii) If the amount determined under subdivision (i)(*b*) of this subparagraph exceeds the amount determined under subdivision (i)(*a*) of this subparagraph, then the applicable percentage of the lower of:

(*a*) The additional depreciation attributable to periods before January 1, 1970, or

(*b*) Such excess,

shall also be recognized as ordinary income.

(iii) If gain would be recognized upon a disposition of an item of section 1250 property under subdivisions (i) and (ii) of this subparagraph, and if section 1250(d) applies, then the gain recognized shall be considered as recognized first under subdivision (i) of this subparagraph. (See example (3)(i) of paragraph (c)(4) of § 1.1250–3.)

(2) *Meaning of terms.* (i) For purposes of section 1250, the term *disposition* shall have the same meaning as in paragraph (a)(3) of § 1.1245–1. *Section 1250 property* is, in general, depreciable real property other than section 1245 property. See paragraph (e) of this section. See paragraph (d)(1) of this section for meaning of the term *applicable percentage*. If, however, the property is considered to have two or more elements with separate periods (for example, because units thereof are placed in service on different dates, improvements are made to the property, or because of the application of paragraph (h) of § 1.1250–3), see the special rules of § 1.1250–5.

(ii) For purposes of applying section 1250, the facts and circumstances of each disposition shall be considered in determining what is the appropriate item of section 1250 property. In general, a building is an item of section 1250 property, but in an appropriate case more than one building may be treated as a single item. For example, if two or more buildings or structures on a single tract or parcel (or contiguous tracts or parcels) of land are operated as an integrated unit (as evidenced by their actual operation, management, financing, and accounting), they may be treated as a single item of section 1250 property. For the manner of determining whether an expenditure shall be treated as an addition to capital account of an item of section 1250 property or as a separate item of section 1250 property, see paragraph (d)(2)(iii) of § 1.1250–5.

(3) *Sale, exchange, or involuntary conversion after December 31, 1969.* (i) In the case of a disposition of section 1250 property by a sale, exchange, or involuntary conversion after December 31, 1969, the gain to which section 1250(a)(1) applies is the applicable percentage for the property (determined under paragraph (d)(1) of this section) multiplied by the lower of (*a*) the additional depreciation in respect of the property attributable to periods after December 31, 1969, or (*b*) the excess (referred to as *gain realized*) of the amount realized over the adjusted basis of the property.

(ii) In addition to gain recognized under section 1250(a)(1) and subdivision (i) of this subparagraph, gain may also be recognized under section 1250(a)(2) and this subdivision if the gain realized exceeds the additional depreciation attributable to periods after December 31, 1969. In such a case, the amount of gain recognized under section 1250(a)(2) and this subdivision is the applicable percentage for the property (determined under paragraph (d)(2) of this section) multiplied by the lower of (*a*)

the additional depreciation attributable to periods before January 1, 1970, or (*b*) the excess (referred to as *remaining gain*) of the gain realized over the additional depreciation attributable to periods after December 31, 1969.

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

Example 1. Section 1250 property which has an adjusted basis of $500,000 is sold for $650,000 after December 31, 1969, and thus the gain realized is $150,000. At the time of the sale the additional depreciation in respect of the property attributable to periods after December 31, 1969, is $190,000 and the applicable percentage is 100 percent (paragraph (d)(1)(i)(*e*) of this section). Since the gain realized ($150,000), is lower than the additional depreciation ($190,000), the amount of gain recognized as ordinary income under section 1250(a)(1) is $150,000 (that is, 100 percent of $150,000). No gain is recognized under section 1250(a)(2).

Example 2. Section 1250 property which has an adjusted basis of $440,000 is sold for $500,000 on December 31, 1974, and thus the gain realized is $60,000. The property was acquired on March 31, 1966. At the time of the sale, the additional depreciation attributable to periods after December 31, 1969, is $20,000, and the additional depreciation attributable to periods before January 1, 1970, is $60,000. The property qualified as residential rental property for each taxable year ending after December 31, 1969, and the applicable percentage is 95 percent (paragraph (d)(1)(i)(*c*) of this section). The applicable percentage under paragraph (d)(2) of this section is 15 percent. Since the additional depreciation attributable to periods after December 31, 1969 ($20,000), is lower than the gain realized ($60,000), the amount of gain recognized as ordinary income under section 1250(a)(1) is $19,000 (that is, 95 percent of $20,000). In addition, gain is recognized under section 1250(a)(2) since there is remaining gain of $40,000 (that is, the gain realized ($60,000) minus the additional depreciation attributable to periods after December 31, 1969 ($20,000)). Since the remaining gain of $40,000 is lower than the additional depreciation attributable to periods before January 1, 1970 ($60,000), the amount of gain recognized as ordinary income under section 1250(a)(2) is $6,000 (that is, 15 percent of $40,000). The remaining $35,000 (that is, gain realized $60,000, minus gain recognized under section 1250(a), $25,000) of the gain may be treated as gain from the sale or exchange of property described in section 1231.

(4) *Other dispositions after December 31, 1969.* (i) In the case of a disposition of section 1250 property after December 31, 1969, other than by way of a sale, exchange, or involuntary conversion, the gain to which section 1250(a)(1) applies is the applicable percentage for the property (determined under paragraph (d)(1) of this section) multiplied by the lower of (*a*) the additional depreciation in respect of the property attributable to periods after December 31, 1969, or (*b*) the excess (referred to as *potential gain*) of the fair market value of the property over its adjusted basis. In addition, if the potential gain exceeds the additional depreciation attributable to periods after December 31, 1969, then the gain to which section 1250(a)(2) applies is the applicable percentage for the property (determined under paragraph (d)(2) of this section) multiplied by the lower of (*c*) the additional depreciation attributable to periods before January 1, 1970, or (*d*) the excess (referred to as *remaining potential gain*) of the potential gain over the additional depreciation attributable to periods after December 31, 1969. If property is transferred by a corporation to a shareholder for an amount less than its fair market value in a sale or exchange, for purposes of applying section 1250 such transfer shall be treated as a disposition other than by way of a sale, exchange, or involuntary conversion.

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

Example 1. Section 1250 property having an adjusted basis of $500,000 and a fair market value of $550,000 is distributed by a corporation to a stockholder in complete liquidation of the corporation after December 31, 1969, and thus the potential gain is $50,000. At the time of the liquidation, the additional depreciation for the property attributable to periods after December 31, 1969, is $80,000 and the applicable percentage is 100 percent (paragraph (d)(1)(i)(*e*) of this section). Since the potential gain of $50,000 is lower than the additional depreciation attributable to periods after December 31, 1969 ($80,000), the amount of gain recognized as ordinary income under section 1250(a)(1) is $50,000 (that is, 100 percent of $50,000) even though in the absence of section 1250, section 336 would preclude recognition of gain to the corporation.

Example 2. The facts are the same as in example (1) except that the fair market value of the property is $650,000, and thus the potential gain is $150,000. Since the additional depreciation attributable to periods after

December 31, 1969 ($80,000), is lower than the potential gain of $150,000, the amount of gain recognized as ordinary income under section 1250(a)(1) is $80,000 (that is, 100 percent of $80,000). In addition, section 1250(a)(2) applies since there is remaining potential gain of $70,000, that is, potential gain ($150,000) minus additional depreciation attributable to periods after December 31, 1969 ($80,000). The additional depreciation attributable to periods before January 1, 1970, is $90,000 and the applicable percentage under paragraph (d)(2) of this section is 50 percent. Since the remaining potential gain of $70,000 is lower than the additional depreciation attributable to periods before January 1, 1970 ($90,000), the amount of gain recognized as ordinary income under section 1250(a)(2) is $35,000 (that is, 50 percent of $70,000). Thus under section 1250(a), $115,000 (that is, $80,000 under section 1250(a)(1), plus $35,000 under section 1250(a)(2)) is recognized as ordinary income, even though in the absence of section 1250, section 336 would preclude recognition of gain to the corporation.

(5) *Instances of nonapplication.* (i) Section 1250(a)(1) does not apply to losses. Thus, section 1250(a)(1) does not apply if a loss is realized upon a sale, exchange, or involuntary conversion of property, all of which is considered section 1250 property, nor does the section apply to a disposition of such property other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of such property is not greater than its adjusted basis.

(ii) In general, in the case of section 1250 property with a holding period under section 1223 of more than 1 year, section 1250(a)(1) does not apply if for periods after December 31, 1969, there are no *depreciation adjustments in excess of straight line* (as computed under section 1250(b) and paragraph (b) of § 1.1250–2).

(6) *Allocation rules.* (i) In the case of a sale, exchange, or involuntary conversion of section 1250 property and nonsection 1250 property in one transaction after December 31, 1969, the total amount realized upon the disposition shall be allocated between the section 1250 property and the other property in proportion to their respective fair market values. Such allocation shall be made in accordance with the principles set forth in paragraph (a)(5) of § 1.1245–1 (relating to allocation between section 1245 property and nonsection 1245 property).

(ii) If an item of section 1250 property has two (or more) applicable percentages because one subdivision of paragraph (d)(1)(i) of this section applies to one portion of the taxpayer's holding period (determined under § 1.1250–4) and another subdivision of such paragraph applies with respect to another such portion, then the gain realized on a sale, exchange, or involuntary conversion, or the potential gain in the case of any other disposition, shall be allocated to each such portion of the taxpayer's holding period after December 31, 1969, in the same proportion as the additional depreciation with respect to such item for such portion bears to the additional depreciation with respect to such item for the entire holding period after December 31, 1969.

(b) *Dispositions before January 1, 1970*—(1) *Ordinary income.* In general, section 1250(a)(2) provides that, upon a disposition of an item of section 1250 property after December 31, 1963, and before January 1, 1970, the applicable percentage of the lower of:

(i) The additional depreciation (as defined in § 1.1250–2) attributable to periods before January 1, 1970, in respect of the property, or

(ii) The excess of the amount realized on a sale, exchange, or involuntary conversion (or the fair market value of the property on any other disposition) over the adjusted basis of the property,

shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income). The amount of such gain shall be determined separately for each item (see subparagraph (2)(ii) of this paragraph) of section 1250 property. For relation of section 1250 to other provisions, see paragraph (c) of this section.

(2) *Meaning of terms.* (i) For purposes of section 1250, the term *disposition* shall have the same meaning as in paragraph (a)(3) of § 1.1245–1. *Section 1250 property* is, in general, depreciable real property other than section 1245 property. See paragraph (e) of this section. For purposes of this paragraph, the term *applicable percentage* means 100 percent minus 1 percentage point for each full month the property was

held after the date on which the property was held 20 full months. See paragraph (d)(2) of this section. If, however, the property is considered to have two or more elements with separate holding periods (for example, because units thereof are placed in service on different dates, or improvements are made to the property), see the special rules of § 1.1250–5.

(ii) For purposes of applying section 1250, the facts and circumstances of each disposition shall be considered in determining what is the appropriate item of section 1250 property. In general, a building is an item of section 1250 property, but in an appropriate case more than one building may be treated as a single item. For manner of determining whether an expenditure shall be treated as an addition to the capital account of an item of section 1250 property or as a separate item of section 1250 property, see paragraph (d)(2)(iii) of § 1.1250–5.

(3) *Sale, exchange, or involuntary conversion before January 1, 1970.* (i) In the case of a disposition of section 1250 property by a sale, exchange, or involuntary conversion before January 1, 1970, the gain to which section 1250(a)(2) applies is the applicable percentage for the property multiplied by the lower of (*a*) the additional depreciation in respect of the property or (*b*) the excess (referred to as *gain realized*) of the amount realized over the adjusted basis of the property.

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

Example: Section 1250 property, which has an adjusted basis of $200,000, is sold for $290,000 before January 1, 1970. At the time of the sale the additional depreciation in respect of the property is $130,000 and the applicable percentage is 60 percent. Since the gain realized ($90,000, that is, amount realized, $290,000, minus adjusted basis, $200,000) is lower than the additional depreciation ($130,000), the amount of gain recognized as ordinary income under section 1250(a)(2) is $54,000 (that is, 60 percent of $90,000). The remaining $36,000 ($90,000 minus $54,000) of the gain may be treated as gain from the sale or exchange of property described in section 1231.

(4) *Other dispositions before January 1, 1970.* (i) In the case of a disposition of section 1250 property before January 1, 1970, other than by way of a sale, exchange, or involuntary conversion, the gain to which section 1250(a)(2) applies is the applicable percentage for the property multiplied by the lower of (*a*) the additional depreciation in respect of the property, or (*b*) the excess (referred to as *potential gain*) of the fair market value of the property on the date of disposition over its adjusted basis. If property is transferred by a corporation to a shareholder for an amount less than its fair market value in a sale or exchange, for purposes of applying section 1250 such transfer shall be treated as a disposition other than by way of a sale, exchange, or involuntary conversion.

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

Example: Assume the same facts as in the example in subparagraph (3)(ii) of this paragraph except that the property is distributed by a corporation to a stockholder before January 1, 1970, in complete liquidation of the corporation, and that at the time of the distribution the fair market value of the property is $370,000. Since the additional depreciation ($130,000) is lower than the potential gain of $170,000 (that is, fair market value, $370,000, minus adjusted basis, $200,000), the amount of gain recognized as ordinary income under section 1250(a)(2) is $78,000 (that is, 60 percent of $130,000) even though, in the absence of section 1250, section 336 would preclude recognition of gain to the corporation.

(5) *Instances of nonapplication.* (i) Section 1250(a)(2) does not apply to losses. Thus, section 1250(a)(2) does not apply if a loss is realized upon a sale, exchange, or involuntary conversion of property, all of which is considered section 1250 property, nor does the section apply to a disposition of such property other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of such property is not greater than its adjusted basis.

(ii) In general, in the case of section 1250 property with a holding period under section 1223 of more than one year, section 1250(a)(2) does not apply if for periods after December 1, 1963, there are no *depreciation adjustments in excess of straight line* (as computed under section 1250(b) and paragraph (b) of § 1.1250–2).

(iii) In a case in which section 1250 property (including each element thereof, if any) has a holding period under § 1.1250–4 (or paragraph (a)(2)(ii) of § 1.1250–5) of at least 10 years, section 1250(a)(2) does not apply. If within the 10-year period preceding the date the property is disposed of, an element is added to the property by reason, for example, of an addition to capital account, see § 1.1250–5.

(6) *Allocation rule.* In the case of a sale, exchange, or involuntary conversion of section 1250 property and nonsection 1250 property in one transaction before January 1, 1970, the total amount realized upon the disposition shall be allocated between the section 1250 property and the other property in proportion to their respective fair market values. Such allocation shall be made in accordance with the principles set forth in paragraph (a)(5) of § 1.1245–1 (relating to allocation between section 1245 property and nonsection 1245 property).

(c) *Relation of section 1250 to other provisions*—(1) *General.* The provisions of section 1250 apply notwithstanding any other provision of subtitle A of the Code. See section 1250(i). Thus, unless an exception or limitation under section 1250(d) and § 1.1250–3 applies, gain under section 1250(a) is recognized notwithstanding any contrary nonrecognition provision or income characterizing provision. For example, since section 1250 overrides section 1231 (relating to property used in the trade or business), the gain recognized under section 1250(a) upon a disposition will be treated as ordinary income and only the remaining gain, if any, from the disposition may be considered as gain from the sale or exchange of a capital asset if section 1231 is applicable. See the example in paragraph (b)(3)(ii) of this section.

(2) *Nonrecognition sections overridden.* The nonrecognition provisions of subtitle A of the Code which section 1250 overrides include, but are not limited to, sections 267(d), 311(a), 336, 337, 501(a), and 512(b)(5). See section 1250(d) for the extent to which section 1250(a) overrides sections 332, 351, 361, 371(a), 374(a), 721, 731, 1031, 1033, 1039, 1071, and 1081 (b)(1) and (d)(1)(A). For amount of additional depreciation in respect of property disposed of by an organization exempt from income taxes (within the meaning of section 501(a)), see paragraph (d)(6) of § 1.1250–2.

(3) *Exempt income.* The fact that section 1250 provides for recognition of gain as ordinary income does not change into taxable income any income which is exempt under section 115 (relating to income of States, etc.), 892 (relating to income of foreign governments), or 894 (relating to income exempt under treaties).

(4) *Treatment of gain not recognized under section 1250.* Section 1250 does not prevent gain which is not recognized under section 1250 from being considered as gain under another provision of the Code, such as, for example, section 1239 (relating to gain from sale of depreciable property between certain related persons). Thus, for example, if section 1250 property which has an adjusted basis of $10,000 is sold for $17,500 in a transaction to which section 1239 applies, and if $5,000 of the gain would be recognized under section 1250(a) then the remaining $2,500 of the gain would be treated as ordinary income under section 1239.

(5) *Normal retirement of asset in multiple asset account.* Section 1250(a) does not require recognition of gain upon normal retirements of section 1250 property in a multiple asset account as long as the taxpayer's method of accounting, as described in paragraph (e)(2) of § 1.167(a)–8 (relating to accounting treatment of asset retirements), does not require recognition of such gain.

(6) *Installment method.* Gain from a disposition to which section 1250(a) applies may be reported under the installment method if such method is otherwise available under section 453 of the Code. In such case, the income (other than interest) on each installment payment shall be deemed to consist of gain to which section 1250(a) applies until all such gain has been reported, and the remaining portion (if any) of such income shall be deemed to consist of other gain. For treatment of amounts as interest on certain deferred payments, see section 483.

(d) *Applicable percentage*—(1) *Definition for purposes of section 1250(a)(1).* (i)

For purposes of section 1250(a)(1), the term *applicable percentage* means:

(*a*) In the case of property disposed of pursuant to a written contract which was, on July 24, 1969, and at all times thereafter binding on the owner of the property, 100 percent minus 1 percentage point for each full month the property was held after the date on which the property was held 20 full months;

(*b*) In the case of property constructed, reconstructed, or acquired by the taxpayer before January 1, 1975, with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act, or housing is financed or assisted by direct loan or tax abatement under similar provisions of State or local laws, and with respect to which the owner is subject to the restrictions described in section 1039(b)(1)(B) (relating to approved dispositions of certain Government-assisted housing projects), 100 percent minus 1 percentage point for each full month of the taxpayer's holding period for the property (determined under § 1.1250–4) during which the property qualified under this sentence, beginning after the date on which the property so qualified for 20 full months.

(*c*) In the case of residential rental property (as defined in section 167(j)(2)(B)) other than that covered by (*a*) and (*b*) of this subdivision, 100 percent minus 1 percentage point for each full month of the taxpayer's holding period for the property (determined under § 1.1250–4) included within a taxable year for which the property qualified as residential rental property, beginning after the date on which the property so qualified for 100 full months.

(*d*) In the case of property with respect to which a deduction was allowed under section 167(k) (relating to the depreciation of expenditures to rehabilitate low-income rental housing), 100 percent minus 1 percentage point for each full month of the taxpayer's holding period (determined under § 1.1250–4) beginning 100 full months after the date on which the property was placed in service.

(*e*) In the case of all other property, 100 percent.

The provisions of (a), (b), and (c) of this subdivision shall not apply with respect to additional depreciation described in section 1250(b)(4). If the taxpayer's holding period under § 1.1250–4 includes a period before January 1, 1970, such period shall be taken into account in applying each provision of this subdivision.

(ii) A single item of property may have two (or more) applicable percentages under the provisions of subdivision (i) of this subparagraph. For example, if the provision of subdivision (i) of this subparagraph which applies to an item of section 1250 property (or to an element of such property if the property is treated as consisting of more than one element under § 1.1250–5) in the taxable year in which the item (or element) is disposed of did not apply to the item (or element) in a prior taxable year which is included within the taxpayer's holding period under § 1.1250–4 and which ends after December 31, 1969, then each provision of subdivision (i) of this subparagraph shall apply only for the period during which the property qualified under such provision.

(iii) If the taxpayer makes rehabilitation expenditures and elects to compute depreciation under section 167(k) with respect to the property attributable to the rehabilitation expenditures, such property will generally constitute a separate improvement under paragraph (c) of § 1.1250–5 and therefore will constitute an element of section 1250 property. For computation of applicable percentage and gain recognized under section 1250(a) in such a case, see paragraph (a) of § 1.1250–5.

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

Example 1. Section 1250 property is sold on December 31, 1970, pursuant to a written contract which was binding on the owner of the property on July 24, 1969, and at all times thereafter. The property was acquired on July 31, 1968. The applicable percentage for the property under subdivision (i)(*a*) of this subparagraph is 91 percent, since the property was held 29 full months.

Example 2. Section 1250 property is sold on June 30, 1978. The property was acquired by a calendar year taxpayer on June 30, 1966. Subdivision (i)(*e*) of this subparagraph applies to the property in 1977 and 1978. However, subdivision (i)(*c*) of this subparagraph applied to the property for the taxable years of 1970 through 1976. Thus, the property has

two applicable percentages under this subparagraph. The period before January 1, 1970 (42 full months), and the period from 1970 through 1976 (84 full months) are both taken into account in determining the applicable percentage under subdivision (i)(*c*) of this subparagraph. Thus, the applicable percentage is 74 percent (that is, 100 percent minus the excess of the holding period taken into account (126 full months) over 100 full months). The applicable percentage for the years 1977 and 1978 is 100 percent under subdivision (i)(*e*) of this subparagraph.

Example 3. Section 1250 property is sold on December 31, 1978. The property was acquired by a calendar year taxpayer on December 31, 1969. The taxpayer made rehabilitation expenditures in 1973 and properly elected to compute depreciation under section 167(k) on the property attributable to the expenditures for the 60-month period beginning on January 1, 1974, the date such property was placed in service. Subdivision (i)(*c*) applies to the property (other than the property with respect to which a deduction was allowed under section 167(k)) for the taxable years of 1970 through 1978 (108 full months) and the applicable percentage for such property is 92 percent. The applicable percentage for the property with respect to which a deduction under section 167(k) was allowed is 100 percent under subdivision (i)(*d*) of this subparagraph, since the holding period for purposes of such subdivision begins on the date such property is placed in service.

Example 4. Section 1250 property is sold by a calendar year taxpayer on March 31, 1974. The property was transferred to the taxpayer by gift on December 31, 1970, and under section 1250(e)(2), the taxpayer's holding period for the property for purposes of computing the applicable percentage includes the transferor's holding period of 80 full months. Subdivision (i)(*c*) of this subparagraph applies to the property in the years 1970 through 1974. The applicable percentage under subdivision (i) (*c*) of this subparagraph is 81 percent, since the period before January 1, 1970 (68 full months), and that portion of the period after December 31, 1969, during which such subdivision applied (51 full months) are taken into account.

(2) *Definition for purposes of section 1250(a)(2).* For purposes of section 1250(a)(2), the term *applicable percentage* means:

(i) In case of property with a holding period of 20 full months or less, 100 percent;

(ii) In case of property with a holding period of more than 20 full months but less than 10 years, 100 percent minus 1 percentage point for each full month the property is held after the date on which the property is held 20 full months; and

(iii) In case of property with a holding period of at least 10 years, zero.

(3) *Holding period.* For purposes of this paragraph, the holding period of property shall be determined under the rules of § 1.1250–4, and not under the rules of section 1223, notwithstanding that the property was acquired on or before December 31, 1963. In the case of a disposition of section 1250 property which consists of 2 or more elements (within the meaning of paragraph (c) of § 1.1250–5), the holding period for each element shall be determined under the rules of paragraph (a)(2)(ii) of § 1.1250–5.

(4) *Full month.* For purposes of this paragraph, the term *full month* (or *full months*) means the period beginning on a date in 1 month and terminating on the date before the corresponding date in the next succeeding month (or in another succeeding month), or, if a particular succeeding month does not have such a corresponding date, terminating on the last day of such particular succeeding month.

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

Example 1. Property is purchased on January 17, 1959. Under paragraph (b)(1) of § 1.1250–4, its holding period begins on January 18, 1959, and thus at any time during the period beginning on October 17, 1960, and ending on November 16, 1960, the property is considered held 21 full months and has an applicable percentage under section 1250(a)(2) of 99 percent. On and after January 17, 1969, the property has a holding period of at least 120 full months (10 years) and, therefore, the applicable percentage under section 1250(a)(2) for the property is zero. Accordingly, no gain would be recognized under section 1250(a)(2) upon disposition of the property. If, however, the property consists of two or more elements, see the special rules of § 1.1250–5.

Example 2. Property is purchased on January 31, 1968. Under paragraph (b)(1) of § 1.1250–4 its holding period begins on February 1, 1968, and thus at any time during the period beginning on February 29, 1968, and ending on March 30, 1968, the property is considered held 1 full month. At any time during the period beginning on March 31, 1970, and ending on April 29, 1970, the property is considered held 26 full months. At any time during the period beginning on April 30, 1970, and ending on May 30, 1970, the property is considered held 27 full months.

(e) *Section 1250 property*—(1) *Definition*. The term *section 1250 property* means any real property (other than section 1245 property, as defined in section 1245(a)(3) and § 1.1245–3) which is or has been property of a character subject to the allowance for depreciation provided in section 167. See section 1250(c).

(2) *Character of property*. For purposes of subparagraph (1) of this paragraph, the term *is or has been property of a character subject to the allowance for depreciation provided in section 167* shall have the same meaning as when used in paragraph (a) (1) and (3) of § 1.1245–3. Thus, if a father uses a house in his trade or business during a period after December 31, 1963, and then gives the house to his son as a gift for the son's personal use, the house is section 1250 property in the hands of the son. For exception to the application of section 1250(a) upon disposition of a principal residence, see section 1250(d)(7).

(3) *Real property*. (i) For purposes of subparagraph (1) of this paragraph, the term *real property* means any property which is not personal property within the meaning of paragraph (b) of § 1.1245–3. The term section 1250 property includes three types of depreciable real property. The first type is intangible real property. For purposes of this paragraph, a leasehold of land or of section 1250 property is intangible real property, and accordingly such a leasehold is section 1250 property. However, a fee simple interest in land is not depreciable, and therefore is not section 1250 property. The second type is a building or its structural components within the meaning of paragraph (c) of § 1.1245–3. The third type is all other tangible real property except (*a*) property described in section 1245(a)(3)(B) as defined in paragraph (c)(1) of § 1.1245–3 (relating to property used as an integral part of a specified activity or as a specified facility), and (*b*) property described in section 1245(a)(3)(D). An elevator or escalator (within the meaning of section 1245(a)(3)(C)) is not section 1250 property.

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

Example: A owns and leases to B for a single lump-sum payment of $100,000 property consisting of land and a fully equipped factory building thereon. If 30 percent of the fair market value of such property is properly allocable to the land, 25 percent to section 1250 property (the building and its structural components), and 45 percent to section 1245 property (the equipment), then 55 percent of B's leasehold is section 1250 property.

(4) *Coordination with definition of section 1245 property*. (i) Property may lose its character as section 1250 property and become section 1245 property. Thus, for example, if section 1250 property of the third type described in subparagraph (3)(i)(*a*) of this paragraph is converted to use as an integral part of manufacturing, the property would lose its character as section 1250 property and would become section 1245 property. However, once property in the hands of a taxpayer is section 1245 property, it can never become section 1250 property in the hands of such taxpayer. See also paragraph (a) (4) and (5) of § 1.1245–2.

(f) *Treatment of partnerships and partners*. If a partnership disposes of section 1250 property, the amount of gain recognized under section 1250(a) by the partnership and by a partner shall be determined in a manner consistent with the principles provided in paragraph (e) of § 1.1245–1. Thus, for example, a partner's distributive share of gain recognized by the partnership under section 1250(a) shall be determined in the same manner as his distributive share of gain recognized by the partnership under section 1245(a)(1) is determined, and, if required, additional depreciation in respect of section 1250 property shall be allocated to the partner in the same manner as the adjustments reflected in the adjusted basis of section 1245 property are allocated to the partner. For a further example, if on the date a partner acquires his partnership interest by way of a sale or exchange the partnership owns section 1250 property and an election under section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to the partnership, then such partner's additional depreciation in respect of such property on such date is deemed to be zero. For limitation on the amount of gain recognized under section 1250(a) in respect of a partnership

and for the amount of additional depreciation in respect of partnership property after certain transactions, see paragraph (f) of § 1.1250–3. For treatment of section 1250 property as an unrealized receivable, see section 751(c).

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

Example 1. Section 1250 property which has an adjusted basis of $350,000 is sold for $630,000 on December 31, 1984. The property was acquired by a calendar year taxpayer on December 31, 1969. For the taxable years from 1970 through 1980, the property qualified as residential rental property and the applicable percentage for those years is 68 percent (paragraph (d)(1)(i)(*c*) of this section). For taxable years from 1981 through 1984, the property did not qualify as residential rental property and the applicable percentage for those years is 100 percent (paragraph (d)(1)(i)(*e*) of this section). The additional depreciation for the years from 1970 through 1980 is $120,000. The additional depreciation for the years from 1981 through 1984 is $20,000. The gain realized is $280,000 (that is, amount realized, $630,000, minus adjusted basis $350,000). The gain recognized as ordinary income under section 1250(a)(1) is computed in two steps. First, since the additional depreciation attributable to the years 1970 through 1980 ($120,000) is lower than the gain realized attributable to such years determined under paragraph (a)(6) of this section ($240,000, that is, gain realized, $280,000, multiplied by 12/14), the gain recognized as ordinary income under section 1250(a)(1) in the first step is $81,600, that is, 68 percent of $120,000. Second, since the additional depreciation attributable to the years 1981 through 1984 ($20,000) is lower than the gain realized attributable to those years ($40,000, that is, gain realized, $280,000, multiplied by 2/14), the gain recognized as ordinary income under section 1250(a)(1) for the years from 1981 through 1984 is $20,000 (that is, 100 percent of $20,000). The total gain recognized under section 1250(a)(1) is $101,600 (that is, $81,600 plus $20,000).

Example 2. Section 1250 property which has an adjusted basis of $400,000 is sold for $472,000 on December 31, 1978. The property was acquired on December 31, 1966. The additional depreciation attributable to periods before January 1, 1970, is $40,000 and the applicable percentage under paragraph (d)(2) of this section is zero percent. The property qualifies as residential rental property for the years 1970 through 1976, but fails to qualify for 1977 and 1978. Under paragraph (d)(1) of this section, the applicable percentage for the years 1970 through 1976 is 80 percent (paragraph (d)(1)(i)(*c*) of this section), and the applicable percentage for the years 1977 and 1978 is 100 percent (paragraph (d)(1)(i)(*e*) of this section). The additional depreciation attributable to the years 1970 through 1976 is $50,000, and the additional depreciation attributable to the years 1977 and 1978 is $10,000. The gain recognized as ordinary income under section 1250(a)(1) is computed in two steps. First, since the additional depreciation attributable to the years 1970 through 1976 ($50,000) is lower than the gain realized attributable to such years ($60,000, that is, $72,000 multiplied by 5/6), the gain recognized under section 1250(a)(1) in the first step is $40,000 (that is, 80 percent of $50,000). Second, since the additional depreciation attributable to 1977 and 1978 ($10,000) is lower than the gain realized attributable to such years ($12,000, that is, $72,000 multiplied by 1/6), the gain recognized under section 1250(a)(1) in the second step is $10,000 (that is, 100 percent of $10,000). In addition, section 1250(a)(2) applies. However, since the applicable percentage is zero percent, none of the gain is recognized as ordinary income under section 1250(a)(2). Thus, the remaining $22,000 (that is, gain realized, $72,000, minus gain recognized under section 1250(a), $50,000) of the gain may be treated as gain from the sale or exchange of property described in section 1231.

Example 3. The facts are the same as in example (2) except that the property is disposed of on December 31, 1980. The property qualifies as residential rental property for the years 1979 and 1980. Thus, the applicable percentage for years 1970 through 1976, 1979, and 1980 is 56 percent (paragraph (d)(1)(i)(*c*) of this section). The applicable percentage for the years 1977 and 1978 is 100 percent (paragraph (d)(1)(i)(*e*) of this section). The additional depreciation for the years 1979 and 1980 is $8,000. The gain recognized under section 1250(a)(1) is computed in two steps. First, since the additional depreciation attributable to the years 1970 through 1976, 1979, and 1980 ($58,000) is lower than the gain realized attributable to such years ($61,412, that is, $72,000 multiplied by $58,000/$68,000), the gain recognized under section 1250(a)(1) in the first step is $32,480 (that is, 56 percent of $58,000). Second, since the additional depreciation attributable to 1977 and 1978 ($10,000) is lower than the gain realized attributable to such years ($10,588, that is, $72,000 multiplied by $10,000/$68,000) the gain recognized under section 1250(a)(1) in the second step is $10,000 (that is, 100 percent of $10,000). In addition section 1250(a)(2) applies. However, since the applicable percentage is zero percent, none of the gain is recognized as ordinary income under section 1250(a)(2). Thus, the remaining $29,520 (that is, gain realized, $72,000, minus gain recognized under section 1250(a), $42,480) of the gain may be

treated as gain from the sale or exchange of property described in section 1231.

[T.D. 7084, 36 FR 271, Jan. 8, 1971, as amended by T.D. 7193, 37 FR 12953, June 30, 1972]

§ 1.1250–2 Additional depreciation defined.

(a) *In general*—(1) *Definition for purposes of section 1250(b)(1)*. Except as otherwise provided in paragraph (e) of this section, for purposes of section 1250(b)(1), the term *additional depreciation* means:

(i) In the case of property which at the time of disposition has a holding period under section 1223 of not more than 1 year, the *depreciation adjustments* (as defined in paragraph (d) of this section) in respect of such property for periods after December 31, 1963, and

(ii) In the case of property which at the time of disposition has a holding period under section 1223 of more than 1 year, the depreciation adjustments in excess of straight line for periods after December 31, 1963, computed under paragraph (b)(1) of this section.

(2) *Definition for purposes of section 1250(b)(4)*. Except as otherwise provided in paragraph (e) of this section, for purposes of section 1250(b)(4), the term *additional depreciation* means:

(i) In the case of property with respect to which a deduction under section 167(k) (relating to depreciation of expenditures to rehabilitate low-income rental housing) was allowed, which at the time of disposition has a holding period under section 1223 of not more than 1 year from the time the rehabilitation expenditures were incurred, the *depreciation adjustments* (as defined in paragraph (d) of this section) in respect of the property, and

(ii) In the case of property with respect to which a deduction under section 167(k) (relating to depreciation of expenditures to rehabilitate low-income rental housing) was allowed, which at the time of disposition has a holding period under section 1223 of more than 1 year from the time the rehabilitation expenditures were incurred, the depreciation adjustments in excess of straight line for the property, computed under paragraph (b)(2) of this section.

For purposes of this subparagraph, all rehabilitation expenditures which are incurred in connection with the rehabilitation of an element of section 1250 property shall be considered incurred on the date the last such expenditure is considered incurred under the accrual method of accounting, regardless of the method of accounting used by the taxpayer with regard to other items of income and expense. If the property consists of two or more elements (for example, if the property is placed in service at different times), then each element shall be treated as if it were a separate property and the expenditures attributable to each such element shall be considered incurred on the date the last such expenditure is considered incurred.

(3) *Allocation to certain periods*. With respect to a taxable year beginning in 1963 and ending in 1964, or beginning in 1969 and ending in 1970, the amount of depreciation adjustments or of depreciation adjustments in excess of straight line (as the case may be) shall be ascertained by applying the principles of paragraph (c)(3) of § 1.167(a)–8 (relating to determination of adjusted basis of retired asset), and the amount determined in such manner shall be allocated on a daily basis in order to determine the portion thereof which is attributable to a period after December 31, 1963, or after December 31, 1969, as the case may be.

(b) *Computation of depreciation adjustments in excess of straight line*—(1) *General rule*. For purposes of paragraph (a)(1) of this section, depreciation adjustments in excess of straight line shall be, in the case of any property, the excess of (i) the sum of the *depreciation adjustments* (as defined in paragraph (d) of this section) in respect of the property attributable to periods after December 31, 1963, over (ii) the sum such adjustments would have been for such periods if such adjustments had been determined for the entire period the property was held under the straight line method of depreciation (or, if applicable, under the lease-renewal-period provision in paragraph (c) of this section). Depreciation in excess of straight line may arise, for example, if the declining balance method, the sum of the years-digits method, or the

units of production method is used, or for another example, if the cost of a leasehold improvement or of a leasehold is depreciated over a period which does not take into account certain renewal periods referred to in paragraph (c) of this section. For computations of depreciation adjustments in excess of straight line (or a deficit therein) both on an annual basis and on the basis of the entire period the property was held, see subparagraph (6) of this paragraph.

(2) *Depreciation under section 167(k).* For purposes of paragraph (a)(2) of this section, depreciation adjustments in excess of straight line shall be, in the case of any property with respect to which a deduction was allowed under section 167(k) (relating to depreciation of expenditures to rehabilitate low-income rental housing), the excess of (i) the sum of the *depreciation adjustments* (as defined in paragraph (d) of this section) allowed in respect of the property, over (ii) the sum such adjustments would have been if such adjustments had been determined for the entire period the property was held under the straight line method of depreciation permitted by section 167(b)(1).

(3) *General rule for computing useful life and salvage value.* For purposes of computing under subparagraph (1)(ii) of this paragraph the sum of the depreciation adjustments would have been under the straight line method, if a useful life (or salvage value) was used in determining the amount allowed as a depreciation adjustment for any taxable year, such life (or value) shall be used in determining the amount such depreciation adjustment would have been for such taxable year under the straight line method. If, however, for any taxable year a method of depreciation was used as to which a useful life was not taken into account such as, for example, the units of production method, or as to which salvage value was not taken into account in determining the annual allowances, such as, for example, the declining balance method or the amortization of a leasehold improvement over the term of a lease, then, for the purpose of determining the amount such depreciation adjustment would have been under the straight line method for such taxable year:

(i) There shall be used the useful life (or salvage value) which would have been proper if depreciation had actually been determined under the straight line method throughout the period the property was held, and

(ii) Such useful life (or such salvage value) shall 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.

(4) *Special rule for computing useful life and salvage value (section 167(k)).* For purposes of computing under subparagraph (2)(ii) of this paragraph the sum the depreciation adjustments would have been under the straight line method, the useful life and salvage value permitted under section 167(k) shall not apply, the useful life of the property shall be determined under paragraph (b) of § 1.167(a)–1 (or, if applicable, under the lease-renewal-period provision of paragraph (c) of this section), and the salvage value of the property shall be determined under paragraph (c) of § 1.167(a)–1. Such useful life or salvage value shall 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 the straight line method permitted under section 167(b)(1) throughout the period the property was held.

(5) *Property held before January 1, 1964.* In the case of property held before January 1, 1964:

(i) For purposes of computing under subparagraph (1)(ii) of this paragraph the sum the depreciation adjustments would have been under the straight line method, the adjusted basis of the property on such date shall be the amount such adjusted basis would have been if depreciation deductions allowed or allowable before such date had been determined under the straight line method computed in accordance with subparagraph (3) of this paragraph, and

(ii) The depreciation adjustments in excess of straight line in respect of the property computed under subparagraph

(1) of this paragraph, but without regard to this subdivision, shall be reduced by the amount of depreciation adjustments less than straight line for periods before January 1, 1964, that is, by the excess (if any) of the sum the depreciation adjustments would have been for periods before January 1, 1964, under the straight line method, over the sum of the depreciation adjustments attributable to periods before such date.

(6) *Determination of additional depreciation in certain cases.* If an item of section 1250 property is subject to two (or more) applicable percentages, a separate computation of additional depreciation shall be made for the portion of the taxpayer's holding period subject to each such percentage. That is, a separate computation shall be made to determine the excess of (i) the depreciation adjustments (as defined in paragraph (d) of this section) for each such portion of the taxpayer's holding period after December 31, 1963, over (ii) the amount such adjustments would have been for each such portion if such adjustments were determined under the straight line method of depreciation (or, if applicable, under the lease-renewal-period provision in paragraph (c) of this section). Thus, for example, in the case of an item of section 1250 property acquired on January 1, 1968, and disposed of on January 1, 1973, if the applicable percentage for the period before January 1, 1970, were determined under paragraph (d)(2) of § 1.1250–1 and the applicable percentage for the period after December 31, 1969, were determined under paragraph (d)(1)(i)(*e*) of § 1.1250–1, the additional depreciation would be computed separately for the period before January 1, 1970, and for the period after December 31, 1969. If the additional depreciation attributable to any such portion of the taxpayer's holding period is a deficit (that is, if the depreciation adjustments for that portion are less than the amount such adjustments would have been for that portion if depreciation adjustments were determined for the entire period the property was held under the straight line method of depreciation, or, if applicable, under the lease-renewal-period provision in paragraph (c) of this section), then such deficit will be applied to reduce the additional depreciation for other portion (or portions) of the taxpayer's holding period. (See examples (4) and (5) of subparagraph (7) of this paragraph.)

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

Example 1. A calendar year taxpayer sells section 1250 property on January 1, 1968, which he purchased for $10,000 on January 1, 1963. For the period of 1963 through 1967 he computed depreciation deductions in respect of the property under the declining balance method using a rate of 200 percent of the straight line rate and a proper useful life of 10 years. Under such method salvage value is not taken into account in computing annual allowances. For purposes of applying subparagraph (3) of this paragraph, if the taxpayer had used the straight line method for such period, he would have used a salvage value of $1,000, and the depreciation under the straight line method would have been $900 each year, that is, one-tenth of $10,000 minus $1,000. As of January 1, 1968, the additional depreciation for the property is $1,123, as computed in the table below:

Year	Actual depreciation	Straight line	Additional depreciation (deficit)
1963	$2,000	$900	.....
1964	1,600	900	$700
1965	1,280	900	380
1966	1,024	900	124
1967	819	900	(81)
Sum for periods after Dec. 31, 1963	4,723	3,600	1,123

Example 2. Assume the same facts as in example (1) except that the taxpayer sells the section 1250 property on January 1, 1970. Assume further that as of January 1, 1968, the taxpayer elects under section 167(e)(1) to change to the straight line method. On that date the adjusted basis of the property is $3,277 ($10,000 minus $6,723). He redetermines the remaining useful life of the property to be 8 years and its salvage value to be $77, and thus takes depreciation deductions for 1968 and 1969 of $400 (the amount allowable) for each such year, that is, one-eighth of $3,200 (that is, $3,277 minus $77). For purposes of applying subparagraph (3) of this paragraph, if he had used the straight line method throughout the period he held the property, the adjusted basis of the property on January 1, 1968, would have been $5,500 ($10,000 minus $4,500), and the depreciation which would have resulted under such method for 1968 and 1969 would have been $678 for each such year, that is, one-eighth of $5,423 ($5,500

minus $77). As of January 1, 1970, the additional depreciation for the property is $567, as computed in the table below:

Years	Depreciation	Straight line	Additional depreciation (deficit)
1964 through 1967 ..	$4,723	$3,600	$1,123
1968	400	678	(278)
1969	400	678	(278)
Sum for periods after Dec. 31, 1963	5,523	4,956	567

Example 3. On January 1, 1978, a calendar year taxpayer sells section 1250 property. The property, which is attributable to rehabilitation expenditures of $50,000 incurred in 1970, was placed in service on January 1, 1971. The taxpayer elected to compute depreciation for the period of 1971 through 1975 under section 167(k). Under such section salvage value is not taken into account in computing annual allowances, and the useful life of the property is deemed to be 5 years. For purposes of applying subparagraph (4) of this paragraph, if the taxpayer had used the straight line method permitted under section 167(b)(1) for such period, he would have used a salvage value of $5,000 and a useful life of 15 years. Depreciation under the straight line method would thus have been $3,000 each year, 1/15 of $45,000 (that is, $50,000 minus $5,000). As of January 1, 1978, the additional depreciation for the property is $29,000, as computed in the table below:

Year	Actual depreciation	Straight line	Additional depreciation (deficit)
1971	$10,000	$3,000	$7,000
1972	10,000	3,000	7,000
1973	10,000	3,000	7,000
1974	10,000	3,000	7,000
1975	10,000	3,000	7,000
1976		3,000	(3,000)
1977	.....	3,000	(3,000)
Total	50,000	21,000	29,000

Example 4. Section 1250 property which has an adjusted basis of $108,000 is sold for $146,000 on December 31, 1972, and thus the gain realized is $38,000. The property was acquired on December 31, 1963. The applicable percentage for the period before January 1, 1970, is 12 percent (paragraph (d)(2) of § 1.1250–1) and the applicable percentage for the period after December 31, 1969, is 100 percent (paragraph (d)(1)(i)(*e*) of § 1.1250–1). The additional depreciation must be computed separately for the period before January 1, 1970, and for the period after December 31, 1969. Assume that the additional depreciation for the period before January 1, 1970, is $32,000 and that there is a deficit in additional depreciation of $2,000 for the period after December 31, 1969. Accordingly, the additional depreciation for the period before January 1, 1970 ($32,000) is reduced to $30,000 by the $2,000 deficit in additional depreciation for the period after December 31, 1969. Although section 1250(a)(1) applies to the property, none of the gain is recognized as ordinary income under that section since there is a deficit in additional depreciation for the period after December 31, 1969. Gain is recognized under section 1250(a)(2) since there is remaining gain of $38,000 (that is, gain realized, $38,000, minus the additional depreciation attributable to periods after December 31, 1969, zero). Since the additional depreciation attributable to the period before January 1, 1970 ($30,000), is lower than the gain realized ($38,000), the amount of gain recognized under section 1250(a)(2) is $3,600 (that is, 12 percent of $30,000).

Example 5. Section 1250 property which has an adjusted basis of $207,000 is sold for $267,000 on February 24, 1988, and thus the gain realized is $60,000. The property was acquired on April 30, 1970. The applicable percentage for the period from April 30, 1970, through December 31, 1981, is 60 percent (paragraph (d)(1)(i)(c) of § 1.1250–1) and the applicable percentage for the period from January 1, 1982, through February 24, 1988, is 100 percent (paragraph (d)(1)(i)(e) of § 1.1250–1). The additional depreciation must be computed separately for the period before January 1, 1982, and for the period after December 31, 1981. Assume that the additional depreciation for the period before January 1, 1982, is $43,000 and that there is a deficit in additional depreciation of $6,000 for the period after December 31, 1981. Accordingly, the additional depreciation for the period before January 1, 1982 ($43,000), is reduced to $37,000 by the $6,000 deficit for the period after December 31, 1981. There is no gain recognized under section 1250(a)(1) for the period after December 31, 1981, since there is a deficit in additional depreciation for that period. The gain recognized under section 1250(a)(1) for the period before January 1, 1982, is $22,200, that is, the lower of the gain realized attributable to that period ($60,000) or the additional depreciation attributable to that period ($37,000), or $37,000, multiplied by 60 percent, the applicable percentage.

(c) *Property held by lessee*—(1) *Amount depreciation would have been.* For purposes of paragraph (b) of this section, in case of a leasehold which is section 1250 property, in determining the amount the depreciation adjustments would have been under the straight line method in respect of any building or other improvement (which is section 1250 property) erected or made on the leased property, or in respect of any cost of acquiring the lease, the lease

period shall be treated as including all renewal periods. See section 1250(b)(2). For determination of the extent to which a leasehold is section 1250 property, see paragraph (e)(3) of § 1.1250–1.

(2) *Renewal period*. (i) For purposes of this paragraph, the term *renewal period* means any period for which the lease may be renewed, extended, or continued pursuant to an option or options exercisable by the lessee (whether or not specifically provided for in the lease) except that the inclusion of one or more renewal periods shall not extend the period taken into account by more than two-thirds of the period on the basis of which the depreciation adjustments were allowed.

(ii) In respect of the cost of any building erected (or other improvement made) on the leased property by the lessee, or in respect of the portion of the cost of acquiring a leasehold which is attributable to an existing building (or other improvement) on the leasehold at the time the lessee acquires the leasehold, the inclusion of one or more renewal periods shall not extend the period taken into account to a period which exceeds the useful life remaining, at the time the leasehold is disposed of, of such building (or such other improvement). Determinations under this subdivision shall be made without regard to the proper period under section 167 or 178 for depreciating or amortizing a leasehold acquisition cost or improvement.

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

Example: Assume that a leasehold improvement with a useful life of 30 years is properly amortized on the basis of a 10-year initial lease term. The lease is renewable for an additional 9 years. The period taken into account is 16⅔ years, that is, 10 years plus two-thirds of 10 years. If, however, the leasehold improvement were disposed of at the end of 12 years, and if its remaining useful life were only 3 years, then the period taken into account would be 15 years.

(d) *Depreciation adjustments*—(1) *General*. For purposes of this section, the term *depreciation adjustments* means, in respect of any property, all adjustments reflected in the adjusted basis of such property on account of deductions described in subparagraph (2) of this paragraph allowed or allowable (whether in respect of the same or other property) to the taxpayer or to any other person. For cases where the taxpayer can establish that the amount allowed for any period was less than the amount allowable, see subparagraph (4) of this paragraph. For determination of adjusted basis of property in a multiple asset account, see paragraph (c)(3) of § 1.167(a)–8. The term *depreciation adjustments* as used in this section does not have the same meaning as the term *adjustments reflected in the adjusted basis* as defined in paragraph (a)(2) of § 1.1245–2.

(2) *Deductions*. The deductions described in this subparagraph are allowances (and amounts treated as allowances) for depreciation or amortization (other than amortization under section 168, 169 (as enacted by section 704(a), Tax Reform Act of 1969 (83 Stat. 667)), or 185). Thus, for example, such deductions include a reasonable allowance for exhaustion, wear, and tear (including a reasonable allowance for obsolesence) under section 167, the periodic deductions referred to in § 1.162–11 in respect of a specified sum paid for the acquisition of a leasehold and in respect of the cost to a lessee of improvements on property of which he is the lessee. However, such deductions do not include deductions for the periodic payment of rent.

(3) *Depreciation of other taxpayers or in respect of other property*. (i) The depreciation adjustments (reflected in the adjusted basis) referred to in subparagraph (1) of this paragraph (*a*) are not limited to adjustments with respect to the property disposed of, nor to those allowed or allowable to the taxpayer disposing of such property, and (*b*) except as provided in subparagraph (4) of this paragraph, are taken into account, whether allowed or allowable in respect of the same or other property and whether to the taxpayer or to any other person. For manner of determining the amount of additional depreciation after certain dispositions, see paragraph (e) of this section.

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

Example: On January 1, 1966, a calendar year taxpayer purchases for $100,000 a building for use in his trade or business. He takes depreciation deductions of $20,000 (the amount allowable), of which $3,000 is additional depreciation, and transfers the building to his son as a gift on January 1, 1968. Since the exception for gifts in section 1250(d)(1) applies, the taxpayer does not recognize gain under section 1250(a)(2). In the son's adjusted basis of $80,000 for the building there is reflected $3,000 of additional depreciation. On January 1, 1969, after taking a depreciation deduction of $10,000 (the amount allowable), of which $1,000 is additional depreciation, the son sells the building. At the time of the sale the additional depreciation is $4,000 ($3,000 allowed the father plus $1,000 allowed the son).

(4) *Depreciation allowed or allowable.* (i) For purposes of subparagraph (1) of this paragraph, generally all deductions (described in subparagraph (2) of this paragraph) allowed or allowable shall be taken into account. See section 1016(a)(2) and the regulations thereunder for the meaning of *allowed* and *allowable.* However, if a taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for any period was less than the amount allowable for such period, the amount to be taken into account for such period shall be the amount allowed. The preceding sentence shall not apply for purposes of computing under paragraph (b)(1)(ii) of this section the amount such deductions would have been under the straight line method.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

Example: In the year 1969 it becomes necessary to determine the additional depreciation in respect of section 1250 property, the adjusted basis of which reflects a depreciation adjustment of $1,000 with respect to depreciation deductions allowable for the calendar year 1965 under the sum of the years-digits method. Under paragraph (b)(1)(ii) of this section, the depreciation which would have resulted under the straight line method for 1965 is $800. If the taxpayer can establish by adequate records or other sufficient evidence that he did not take, and was not allowed, any deduction for depreciation in respect of the property in 1965, then, for purposes of computing the depreciation adjustments in excess of straight line in respect of the property, the amount to be taken into account for 1965 as allowed or allowable is zero, and the amount to be taken into account in computing deductions which would have resulted under the straight line method in 1965 is $800. Thus, in effect, there is a deficit in additional depreciation for 1965 of $800.

(5) *Retired or demolished property.* Depreciation adjustments referred to in subparagraph (1) of this paragraph generally do not include adjustments in respect of retired or demolished portions of an item of section 1250 property. If a retired or demolished portion is replaced in a disposition described in section 1250(d)(4)(A) (relating to like kind exchanges and involuntary conversions), see paragraph (d)(7) of § 1.1250–3.

(6) *Exempt organization.* In respect of property disposed of by an organization which is or was exempt from income taxes (within the meaning of section 501(a), the depreciation adjustments (reflected in the adjusted basis) referred to in subparagraph (1) of this paragraph shall include only adjustments allowed or allowable (i) in computing unrelated business taxable income (as defined in section 512(a)), or (ii) in computing taxable income of the organization for a period during which it was not exempt or, by reason of the application of section 502, 503, or 504, was denied its exemption.

(e) *Additional depreciation immediately after certain acquisitions*—(1) *Zero.* If on the date a person acquires property his basis for the property is determined solely (i) by reference to its cost (within the meaning of section 1012), (ii) by reason of the application of section 301(d) (relating to basis of property received in corporate distribution) or section 334(a) (relating to basis of property received in a liquidation in which gain or loss is recognized), or (iii) under the rules of section 334 (b)(2) or (c) (relating to basis of property received in certain corporate liquidations), then on such date the additional depreciation for the property is zero.

(2) *Transactions referred to in section 1250(d).* In the case of property acquired in a disposition described in section 1250(d) (relating to exceptions and limitations to application of section 1250), additional depreciation shall be computed in accordance with the rules prescribed in § 1.1250–3.

(f) *Records to be kept and information to be filed*—(1) *Records to be kept*. In any case in which it is necessary to determine the additional depreciation of an item of section 1250 property, the taxpayer shall have available permanent records of all the facts necessary to determine with reasonable accuracy the amount of such additional depreciation, including the following:

(i) The date, and the manner in which, the property was acquired,

(ii) The taxpayer's basis on the date the property was acquired and the manner in which the basis was determined,

(iii) The amount and date of all adjustments to the basis of the property allowed or allowable to the taxpayer for depreciation adjustments referred to in paragraph (d)(1) of this section and the amount and date of any other adjustments by the taxpayer to the basis of the property, and

(iv) In the case of section 1250 property which has an adjusted basis reflecting depreciation adjustments referred to in paragraph (d)(1) of this section taken by the taxpayer with respect to other property, or by another taxpayer with respect to the same or other property, the information described in subdivisions (i), (ii), and (iii) of this subparagraph with respect to such other property or such other taxpayer.

(2) *Information to be filed*. If a taxpayer acquires in a transaction (other than a like kind exchange or involuntary conversion described in section 1250(d)(4)) section 1250 property which has a basis reflecting depreciation adjustments referred to in paragraph (d)(1) of this section allowed or allowable to another taxpayer, then the taxpayer shall file with its income tax return or information return for the taxable year in which the property is acquired a statement showing all information described in subparagraph (1) of this paragraph. See section 6012 (relating to persons required to make returns of income) and part III of subchapter A of chapter 61 of the Code (relating to information returns).

[T.D. 7084, 36 FR 273, Jan. 8, 1971, as amended by T.D. 7193, 37 FR 12956, June 30, 1972]

§ 1.1250–3 Exceptions and limitations.

(a) *Exception for gifts*—(1) *General rule*. Section 1250(d)(1) provides that no gain shall be recognized under section 1250(a) upon a disposition by gift. For purposes of this paragraph, the term *gift* shall have the same meaning as in paragraph (a) of § 1.1245–4. For reduction in amount of charitable contribution in case of a gift of section 1250 property, see section 170(e) and paragraph (c)(3) of § 1.170–1.

(2) *Disposition in part a sale or exchange and in part a gift*. Where a disposition of property is in part a sale or exchange and in part a gift, the disposition shall be subject to the provisions of § 1.1250–1 and the gain to which section 1250(a) applies, shall be computed under that section.

(3) *Treatment of property in hands of transferee*. If property is disposed of in a transaction which is a gift:

(i) The additional depreciation for the property in the hands of the transferee immediately after the disposition shall be an amount equal to (a) the amount of the additional depreciation for the property in the hands of the transferor immediately before the disposition, minus (b) the amount of any gain (in case the disposition is in part a sale or exchange and in part a gift) which would have been taken into account under section 1250(a) by the transferor upon the disposition if the applicable percentage had been 100 percent.

(ii) For purposes of computing the applicable percentage, the holding period under section 1250(e)(2) of property received as a gift in the hands of the transferee includes the transferor's holding period,

(iii) In case of a disposition which is in part a sale or exchange and in part a gift, if the adjusted basis of the property in the hands of the transferee exceeds its adjusted basis immediately before the transfer, the excess is an addition to capital account under paragraph (d)(2)(ii) of § 1.1250–5 (relating to property with 2 or more elements), and

(iv) If the property disposed of consists of two or more elements within the meaning of paragraph (c) of § 1.1250–5, see paragraph (e)(1) of § 1.1250–5 for the amount of additional depreciation

and holding period for each element in the hands of the transferee.

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

Example 1. (i) On May 15, 1967, Smith transfers section 1250 property to his son for $45,000. In the hands of Smith the property had an adjusted basis of $40,000 and a fair market value of $70,000. Thus, the gain realized is $5,000 (amount realized, $45,000, minus adjusted basis, $40,000), and Smith has made a gift of $25,000 (fair market value, $70,000, minus amount realized, $45,000).

(ii) Smith's holding period for the property is 80 full months and, thus, the applicable percentage under section 1250(a)(2) is 40 percent. The additional depreciation for the property is $10,000. Since the gain realized ($5,000) is lower than the additional depreciation ($10,000), Smith recognized as ordinary income under section 1250(a)(2) gain of $2,000 (that is, applicable percentage, 40 percent, multiplied by gain realized, $5,000) and the $3,000 remaining portion of the gain realized may be treated as gain from the sale of property described in section 1231.

(iii) On the date the son receives the property, the additional depreciation for the property in his hands is $5,000, that is, the additional depreciation for the property in the hands of the father immediately before the transfer ($10,000), minus the gain which would have been recognized under section 1250(a)(2) upon the transfer if the applicable percentage had been 100 percent ($5,000); for purposes of computing applicable percentage his holding period is his father's holding period of 80 full months; and under § 1.1015–4 his unadjusted basis for the property is $45,000, that is, the amount he paid ($45,000) plus the excess (zero) of his father's adjusted basis over such amount.

(iv) The son sells the property for $80,000 on March 15, 1968, 10 full months after he received it from his father. Thus, his holding period is 90 full months (his father's holding period of 80 full months plus the 10 full months the son actually owned the property) and the applicable percentage under section 1250(a)(2) is 30 percent. Assume that no depreciation was allowed or allowable to the son. Thus, the son's adjusted basis and additional depreciation for the property on the date of the sale is the same as on the date he received it. Accordingly, the gain realized is $35,000 (selling price of $80,000, minus adjusted basis of $45,000). Since the additional depreciation ($5,000) is lower than the gain realized ($35,000), the son recognizes as ordinary income under section 1250(a)(2) gain of $1,500, that is, applicable percentage (30 percent) multiplied by additional depreciation ($5,000).

Example 2. Assume the same facts as in example (1), except that the son sells the property on June 15, 1969, 25 full months after he received it from his father. Thus, his holding period is 105 full months (his father's holding period of 80 full months plus the 25 full months the son actually owned the property) and the applicable percentage under section 1250(a)(2) is 15 percent. Assume further that on the date of the sale the adjusted basis of the property is $39,000, and that for the period the son actually owned the property there is a deficit in additional depreciation of $2,000. Accordingly, the gain realized is $41,000 (selling price of $80,000, minus adjusted basis of $39,000), and the additional depreciation for the property is $3,000 (that is, the additional depreciation for the property in the hands of the son on the date he received it, as determined in example (1), $5,000, minus the amount of the deficit in additional depreciation for the period the son actually owned the property, ($2,000). Since the additional depreciation ($3,000) is lower than the gain realized ($41,000), the son recognizes as ordinary income under section 1250(a)(2) gain of $450, that is, applicable percentage (15 percent) multiplied by additional depreciation ($3,000).

(b) *Exception for transfers at death*—(1) *General rule*. Section 1250(d)(2) provides that, except as provided in section 691 (relating to income in respect of a decedent), no gain shall be recognized under section 1250(a) upon a transfer at death. For purposes of this paragraph, the term *transfer at death* shall have the same meaning as in paragraph (b) of § 1.1245–4.

(2) *Treatment of transferee*. (i) If as of the date a person acquires property from a decedent such person's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), then (*a*) on the date of death the additional depreciation for the property is zero, and (*b*) for purposes of computing applicable percentage the holding period of the property under section 1250(e)(1)(A) is deemed to begin on the day after the date of death.

(ii) If property is acquired in a transfer at death to which section 1250(d)(2) applies, the amount of the additional depreciation for the property in the hands of the transferee immediately after the transfer shall be the amount (if any) of the additional depreciation in respect of the property allowed the

transferee before the decedent's death, but only to the extent that the basis of the property (determined under section 1014(a)) is required to be reduced under the second sentence of section 1014(b)(9) (relating to adjustments to basis where property is acquired from a decedent prior to his death) by depreciation adjustments referred to in paragraph (d)(1) of § 1.1250–2 which give rise to such additional depreciation. For treatment of such property as having a special element with additional depreciation so computed, see paragraph (c)(5)(i) of § 1.1250–5 (relating to property with two or more elements). For purposes of determining applicable percentage, such special element shall have a holding period which includes the transferee's holding period for such property for the period before the decedent's death.

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

Example 1. On March 6, 1966, Smith dies owning an item of section 1250 property. On March 7, 1968, the executor distributes the property to Smith's son pursuant to a specific bequest of the property in Smith's will. Under section 1014(a)(2) and paragraph (a)(2) of § 1.1014–4, the unadjusted basis of the property in the hands of the son is its fair market value on March 6, 1966 (the date Smith died), and the son is considered to have acquired the property on such date. Under section 1250(e)(1)(A), the son's holding period for the property begins on March 7, 1966 (the day after the day he is considered to have acquired the property). Thus, on March 7, 1968 (the date the property was distributed to the son), the holding period for the property is 24 full months, and the applicable percentage under section 1250(a)(2) is 96 percent. On such date, the additional depreciation for the property includes any additional depreciation in respect of the property for the period the property was possessed by the estate.

Example 2. H purchases section 1250 property in 1965 which he immediately conveys to himself and W, his wife, as tenants by the entirety. Under local law each spouse is entitled to one-half the income from the property. H and W file joint income tax returns for calendar years 1965, 1966, and 1967. Over the 3 years, depreciation allowed in respect of the property was $4,000 (the amount allowable) of which $500 is additional depreciation. One-half of these amounts are allocable to W. Thus, depreciation deductions of $2,000, of which $250 is additional depreciation, are allowable to W. On January 1, 1968, H dies and the entire value of the property at the date of death is included in H's gross estate. Since W's basis for the property (determined under section 1014(a)) is reduced (under the second sentence of section 1014(b)(9)) by the $2,000 depreciation deductions allowed W before H's death of which $250 is additional depreciation, the additional depreciation for the property in the hands of W immediately after H's death is $250.

(c) *Limitation for certain tax-free transactions*—(1) *General*. Section 1250(d)(3) provides that upon a transfer of property described in subparagraph (2) of this paragraph, the amount of gain taken into account by the transferor under section 1250(a) shall not exceed the amount of gain recognized to the transferor on the transfer (determined without regard to section 1250). For purposes of this subparagraph, in case of a transfer of both section 1250 property and nonsection 1250 property in one transaction, the amount realized from the disposition of the section 1250 property shall be deemed to consist of that portion of the fair market value of each property acquired which bears the same ratio to the fair market value of such acquired property as the amount realized from the disposition of the section 1250 property bears to the total amount realized. The preceding sentence shall be applied solely for purposes of computing the portion of the total gain (determined without regard to section 1250) which shall be recognized as ordinary income under section 1250(a). Section 1250(d)(3) does not apply to a disposition of property to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code.

(2) *Transfers covered*. The transfers described in this subparagraph are transfers of property in which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(i) Section 332 (relating to distributions in complete liquidation of an 80 percent or more controlled subsidiary corporation). For application of section 1250(d)(3) to such a complete liquidation, the principles of paragraph (c)(3) of § 1.1245–4 shall apply.

(ii) Section 351 (relating to transfer to a corporation controlled by transferor).

(iii) Section 361 (relating to exchanges pursuant to certain corporate reorganizations).

(iv) Section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings).

(v) Section 374(a) (relating to exchanges pursuant to certain railroad reorganizations).

(vi) Section 721 (relating to transfers to a partnership in exchange for a partnership interest).

(vii) Section 731 (relating to distributions by a partnership to a partner). For special carryover basis rule, see section 1250(d)(6)(A) and paragraph (f)(1) of this section.

(3) *Treatment of property in hands of transferee.* In the case of a transfer described in subparagraph (2) (other than subdivision (vii) thereof) of this paragraph:

(i) The additional depreciation for the property in the hands of the transferee immediately after the disposition shall be an amount equal to (*a*) the amount of the additional depreciation for the property in the hands of the transferor immediately before the disposition, minus (*b*) the amount of additional depreciation necessary to produce an amount equal to the gain taken into account under section 1250(a) by the transferor upon the disposition (taking into account the applicable percentage for the property),

(ii) For purposes of computing applicable percentage, the holding period under section 1250(e)(2) of the property in the hands of the transferee includes the transferor's holding period,

(iii) If the adjusted basis of the property in the hands of the transferee exceeds its adjusted basis immediately before the transferee, the excess is an addition to capital account under paragraph (d)(2)(ii) of § 1.1250–5 (relating to property with 2 or more elements), and

(iv) If the property disposed of consists of 2 or more elements within the meaning of paragraph (c) of § 1.1250–5, see paragraph (e)(1) of § 1.1250–5 for the amount of additional depreciation and the holding period for each element in the hands of the transferee.

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

Example 1. (i) Green transfers section 1250 property on March 1, 1968, to a corporation, which is not exempt from taxation, in exchange for cash of $9,000 and stock in the corporation worth $91,000, in a transaction qualifying under section 351. Thus, the amount realized is $100,000 ($9,000 plus $91,000). The property has an applicable percentage under section 1250(a)(2) of 60 percent, an adjusted basis of $40,000, and additional depreciation of $20,000. The gain realized is $60,000, that is, amount realized ($100,000) minus adjusted basis ($40,000). Since the additional depreciation ($20,000) is lower than the gain realized ($60,000), the amount of gain which would be treated as ordinary income under section 1250(a)(2) would be $12,000 (60 percent of $20,000) if the limitation provided in section 1250(d)(3) did not apply. Since under section 351(b) gain in the amount of $9,000 would be recognized to the transferor without regard to section 1250, the limitation provided in section 1250(d)(3) limits the gain taken into account by the transferor under section 1250(a)(2) to $9,000.

(ii) The amount of additional depreciation for the property in the hands of the transferee immediately after the transfer is $5,000, that is, the amount of additional depreciation before the transfer ($20,000) minus the amount of additional depreciation necessary to produce an amount equal to the gain recognized under section 1250(a)(2) upon the transfer ($15,000, that is, $9,000 of gain recognized divided by 60 percent, the applicable percentage). (If the property is subsequently disposed of, and for the period after the initial transfer there is additional depreciation in respect of the property, then at the time of the subsequent disposition the additional depreciation will exceed $5,000. If, however, for the period after the initial transfer there was a deficit in additional depreciation, then at the time of the subsequent disposition the additional depreciation would be less than $5,000.)

Example 2. (i) Assume the same facts as in example (1) except that the additional depreciation is $10,000. Since additional depreciation ($10,000) is lower than the gain realized ($60,000), the amount of gain which would be treated as ordinary income under section 1250(a)(2) would be $6,000 (60 percent of $10,000) if the limitation provided in section 1250(d)(3) did not apply. Since under section 351(b) gain in the amount of $9,000 would be recognized to the transferor without regard to section 1250, the limitation under section 1250(d)(3) does not prevent treatment of the entire $6,000 as ordinary income under section 1250(a)(2). The $3,000 remaining portion of the $9,000 gain may be treated as gain

from the sale of property described in section 1231.

(ii) Immediately after the transfer, the amount of additional depreciation is zero, that is, the amount of additional depreciation before the transfer ($10,000) minus the amount of additional depreciation necessary to produce an amount equal to the gain taken into account under section 1250(a)(2) upon the transfer ($10,000) that is, $6,000 divided by 60 percent.

Example 3. (i) Miller transfers section 1250 property after December 31, 1969, to a corporation, which is not exempt from taxation, in exchange for cash of $9,000 and stock in the corporation worth $31,000, in a transaction qualifying under section 351. Thus, the amount realized is $40,000 ($9,000 plus $31,000). The property has an applicable percentage under paragraph (d)(1)(i)(*e*) of this section of 100 percent and an applicable percentage under paragraph (d)(2) of this section of 50 percent. The adjusted basis of the property on the date of the transfer is $24,000, and the gain realized is $16,000 (that is, amount realized, $40,000, minus adjusted basis, $24,000). The additional depreciation attributable to periods after December 31, 1969, is $8,000 and the additional depreciation attributable to periods before January 1, 1970, is $12,000. Since the additional depreciation attributable to periods after December 31, 1969 ($8,000), is lower than the gain realized ($16,000), the amount of gain which would be recognized as ordinary income under section 1250(a)(1) would be $8,000 (100 percent of $8,000) if the limitation provided in section 1250(d)(3) did not apply. In addition, gain is recognized under section 1250(a)(2) since there is a remaining potential gain of $8,000 (that is, gain realized, $16,000, minus additional depreciation attributable to periods after December 31, 1969 ($8,000)). Since the remaining potential gain ($8,000) is lower than the additional depreciation attributable to periods before January 1, 1970 ($12,000), the amount of gain which would be recognized under section 1250(a)(2) would be $4,000 (50 percent of $8,000) if the limitation in section 1250(d)(3) did not apply. Since under section 351(b) gain in the amount of $9,000 would be recognized to the transferor without regard to section 1250, the limitation in section 1250(d)(3) limits the gain taken into account by the transferor under section 1250(a) to $9,000. Since the section 1250(a)(1) gain is considered as recognized first under paragraph (a)(1)(iii) of § 1.1250–1, of the $9,000 of gain recognized, $8,000 is recognized under section 1250(a)(1) and $1,000 is recognized under section 1250(a)(2).

(ii) The amount of additional depreciation for the property in the hands of the transferee immediately after the transfer is $10,000, the amount of additional depreciation immediately before the transfer ($20,000), minus the sum of (*a*) the amount of additional depreciation necessary to produce an amount equal to the gain recognized under section 1250(a)(1) upon the transfer, $8,000 (that is, gain recognized under section 1250(a)(1), $8,000, divided by 100 percent, the applicable percentage under section 1250(a)(1)), plus (*b*) the amount of additional depreciation necessary to produce an amount equal to the gain recognized under section 1250(a)(2) upon the transfer, $2,000 (that is, gain recognized under section 1250(a)(2), $1,000, divided by 50 percent, the applicable percentage under section 1250(a)(2)). Of this amount, zero (that is, $8,000 minus $8,000) is attributable to periods after December 31, 1969, and $10,000 ($12,000 minus $2,000) is attributable to periods before January 1, 1970.

(d) *Limitation for like kind exchanges and involuntary conversions*—(1) *Limitation on gain.* (i) Under section 1250(d)(4)(A), if property is disposed of and gain (determined without regard to section 1250) is not recognized in whole or in part under section 1031 (relating to like kind exchanges) or section 1033 (relating to involuntary conversions), then the amount of gain taken into account by the transferor under section 1250(a) shall not exceed the greater of the two limitations set forth in subdivisions (ii) and (iii) of this subparagraph. Immediately after the transfer the basis of the acquired property shall be determined under subparagraph (2), (3), or (4) (whichever is applicable) of this paragraph, and its additional depreciation shall be computed under subparagraph (5) of this paragraph. The holding period of the acquired property for purposes of computing applicable percentage, which is determined under section 1250(e)(1), does not include the holding period of the property disposed of. In the case of a disposition of section 1250 property and other property in one transaction, see subparagraph (6) of this paragraph. In case of a disposition described in section 1250(d)(4)(A) of a portion of this item of property, see subparagraph (7) of this paragraph.

(ii) For purposes of this subparagraph, the first limitation is the sum of:

(*a*) The amount of gain recognized on the disposition under section 1031 or 1033 (determined without regard to section 1250), plus

(*b*) An amount equal to the cost of any stock purchased in a corporation which (without regard to section 1250)

would result in nonrecognition of gain under section 1033(a)(3)(A).

(iii) For purposes of this subparagraph, the second limitation is the excess (if any) of:

(*a*) The amount of gain which would (without regard to section 1250(d)(4)) be taken into account under section 1250(a), over

(*b*) The fair market value (or cost in the case of a transaction described in section 1033(a)(3)) of the section 1250 property acquired in the transaction.

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

Example: A taxpayer receives $96,000 of insurance proceeds upon the destruction of section 1250 property by fire. If section 1250(d)(4)(A) did not apply to the disposition, $16,000 of gain would be recognized under section 1250(a). In acquisitions qualifying under section 1033(a)(3)(A), he uses $90,000 of the proceeds to purchase property similar or related in service or use to the property destroyed, of which $42,000 is for one item of section 1250 property and $48,000 is for one piece of land, and $5,000 of the proceeds to purchase stock in the acquisition of control of a corporation owning property similar or related in service or use to the property destroyed. The taxpayer properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain (determined without regard to section 1250) to $1,000, that is, the excess of the amount realized from the conversion ($96,000) over the cost of the property acquired in acquisitions qualifying under section 1033(a)(3)(A) ($95,000, that is, $90,000 plus $5,000). The amount of gain recognized under section 1250(a) is $6,000, determined in the following manner:

The first limitation:	
(*a*) Amount of gain recognized under section 1033(a)(3), determined without regard to section 1250(a)	$1,000
(*b*) Fair market value of stock in a corporation which qualifies under section 1033(a)(3)(A)	5,000
(*c*) Sum of (*a*) plus (*b*)	6,000
The second limitation:	
(*d*) Amount of gain which would be recognized under section 1250(a) if section 1250(d)(4) did not apply	16,000
(*e*) Cost of section 1250 property acquired in transaction	42,000
(*f*) Excess of (*d*) over (*e*)	0

Since the first limitation ($6,000) exceeds the second limitation (zero), the amount of gain recognized under section 1250(a) is $6,000. The balance ($10,000) of the gain realized ($16,000) is not recognized.

(2) *Basis of property purchased upon involuntary conversion into money.* (i) If section 1250 property is purchased in a compulsory or involuntary conversion to which section 1033(a)(3) applies, and if by reason of the application of section 1250(d)(4)(A) all or part of the gain computed under section 1250(a) is not taken into account, then the basis of the section 1250 property and other purchased property shall be determined under the rules prescribed in this subparagraph. See section 1250(d)(4)(D).

(ii) The total basis of all purchased property, the acquisition of which results in the nonrecognition of any part of the gain realized upon the transaction, shall be (*a*) its cost, reduced by (*b*) the portion of the total gain realized which was not recognized. To the extent that section 1250(d)(4)(A)(i) prevents the purchase of stock from resulting in nonrecognition of gain, the basis of purchased stock is its cost.

(iii) If purchased property consists of both section 1250 property and other property, the total basis computed under subdivision (ii) of this subparagraph shall be allocated between the section 1250 property (treated as a class) and the other property (treated as a class) in proportion to their respective costs, except that for purposes of this subdivision (but not subdivision (iv) of this subparagraph) the cost of the section 1250 property shall be deemed to be the excess of (*a*) its actual cost, over (*b*) the gain not taken into account under section 1250(a) by reason of the application of section 1250(d)(4)(A).

(iv) If the property acquired consists of more than one item of section 1250 property (or of more than one item of other property), the total basis of the section 1250 property (or of the other property), as computed under subdivisions (ii) and (iii) of this subparagraph, shall be allocated to each item of section 1250 property (or other property) in proportion to their respective actual costs.

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

Example 1. Assume the same facts as in the example in subparagraph (1)(iv) of this paragraph. Assume further that the portion of the gain realized which was not recognized

under section 1033(a)(3) or 1250(a) upon the transaction is $60,000, of which the gain computed under section 1250(a) which is not taken into account by reason of the application of section 1250(d)(4)(A) is $10,000, that is, the excess of the gain which would have been recognized under section 1250(a) if section 1250(d)(4)(A) did not apply ($16,000) over the gain recognized under section 1250(a) ($6,000). In such example $95,000 of proceeds were used to purchase property in acquisitions qualifying under section 1033(a)(3)(A) of which $42,000 was for section 1250 property, $48,000 for land, and $5,000 for stock in a corporation. The basis of each acquired property is determined in the following manner:

(*a*) Under subdivision (ii) of this subparagraph, the total basis of the acquired properties (other than the stock) is $30,000, that is, their cost ($90,000, of which $42,000 is for section 1250 property and $48,000 is for land), reduced by the portion of the total gain realized which was not recognized ($60,000).

(*b*) Under subdivision (iii) of this subparagraph, such total basis is allocated between the section 1250 property and the land in proportion to their respective costs, and for this purpose the cost of the section 1250 property is considered to be $32,000, that is, its actual cost ($42,000) minus the gain not recognized under section 1250(a) by reason of the application of section 1250(d)(4)(A) ($10,000). Thus, the basis of the section 1250 property is $12,000 (32/80 of $30,000), and the basis of the land is $18,000 (48/80 of $30,000).

(*c*) The basis of the purchased stock is its cost of $5,000. See last sentence of subdivision (ii) of this subparagraph.

Example 2. Assume the same facts as in example (1) except that the section 1250 property purchased for $42,000 consists of 2 items of such property ($10,500 for C, and $31,500 for D), and that the land purchased for $48,000 consists of 2 pieces of land ($12,000 for X, and $36,000 for Y). Under subdivision (iv) of this subparagraph, the total basis for each class of property is allocated between the individual properties of such class in proportion to their respective actual costs. Thus, the total basis of $12,000, as determined in example (1), for the section 1250 property is allocated as follows:

To C: $12,000 × ($10,500/$42,000)	$3,000
To D: $12,000 × ($31,500/$42,000)	9,000
Total	12,000

The total basis of $18,000, as determined in example (1), for the land is allocated as follows:

To X: $18,000 × ($12,000/$48,000)	$4,500
To Y: $18,000 × ($36,000/$48,000)	13,500
Total	18,000

(3) *Basis of property acquired upon involuntary conversion into similar property.* If property is involuntarily converted into property similar or related in service or use in a transaction to which section 1033(a)(1) applies, and if by reason of the application of section 1250(d)(4)(A) all or part of the gain computed under section 1250(a) is not taken into account, then:

(i) The total basis of the acquired property shall be determined under the first sentence of section 1033(c), and

(ii) If more than one item of property is acquired, such total basis shall be allocated to the individual items of property acquired in accordance with the principles prescribed in subparagraph (2) (iii) and (iv) of this paragraph, except that an amount equivalent to the fair market value of each item of property on the date acquired shall be treated as its actual cost.

(4) *Basis of property acquired in like kind exchange.* If section 1250 property is transferred in an exchange described in section 1031 (a) or (b), and if by reason of the application of section 1250(d)(4)(A) all or part of the gain computed under section 1250(a) is not taken into account, then:

(i) The total basis of the property (including nonsection 1250 property) acquired of the type permitted to be received under section 1031 without recognition of gain or loss shall be determined under section 1031(d), and

(ii) If more than one item of property of such type was received, such total basis shall be allocated to the individual items of property of such type in accordance with the principles prescribed in subparagraph (2) (iii) and (iv) of this paragraph, except that an amount equivalent to the fair market value of each such item of property on the date received shall be treated as its actual cost.

(5) *Additional depreciation for property acquired in like kind exchange or involuntary conversion.* (i) If property is disposed of in a transaction described in section 1031 or 1033, and if by reason of the application of section 1250(d)(4)(A) all or part of the gain computed under section 1250(a) is not taken into account, then the additional depreciation for the acquired property immediately after the transaction (as computed under section 1250(d)(4)(E)) shall be an amount equal to the amount of gain computed under section 1250(a) which

was not taken into account by reason of the application of section 1250(d)(4)(A).

(ii) In case more than one item of section 1250 property is acquired in the transaction, the additional depreciation computed under subdivision (i) of this subparagraph shall be allocated to each such item of section 1250 property in proportion to their respective adjusted bases.

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

Example 1. (a) On January 15, 1969, section 1250 property X is condemned and proceeds of $100,000 are received. On such date, X's adjusted basis is $25,000, the additional depreciation is $10,000, and the applicable percentage under section 1250(a)(2) is 70 percent. Since the additional depreciation ($10,000) is less than the gain realized ($75,000, that is, $100,000 minus $25,000) the amount of gain computed under section 1250(a)(2) (without regard to section 1250(d)(4)(A)) is $7,000, that is, 70 percent of $10,000.

(b) On March 1, 1969, all the proceeds are used to purchase section 1250 property Y in a transaction qualifying under section 1033(a)(3)(A) for nonrecognition of gain. Accordingly, the gain not recognized by reason of the application of section 1033(a)(3)(A) is $75,000, of which $7,000 is gain computed under section 1250(a)(2) which is not taken into account by reason of the application of section 1250(d)(4)(A). See subparagraph (1) of this paragraph.

(c) Immediately after the transaction, Y's basis is $25,000, that is, its cost ($100,000) minus the total gain realized which was not recognized ($75,000), and the additional depreciation (as computed under section 1250(d)(4)(E)) is $7,000, that is, the amount of gain not taken into account under section 1250(a)(2) by reason of the application of section 1250(d)(4)(A).

(d) On December 15, 1969, before any depreciation deductions were allowed or allowable in respect of Y, Y is sold for $90,000. Under section 1250(e)(1), the holding period of Y is 9 months, and thus, under section 1250(a)(2), the applicable percentage is 100 percent. Since the additional depreciation ($7,000) is less than the gain realized ($65,000, that is $90,000 minus $25,000), the amount of gain recognized under section 1250(a)(2) as ordinary income is $7,000, that is, 100 percent of $7,000.

Example 2. Assume the same facts as in example (1), except that property Y was purchased on June 15, 1962, and that 90 full months thereafter, or December 15, 1969, it is sold for $35,000. Thus the applicable percentage under section 1250(a)(2) is 30 percent. Assume further that at the time of such sale Y's adjusted basis is $5,000 and additional depreciation in respect of Y for periods after it was acquired is $2,500. Thus, the additional depreciation at the time of the sale is $9,500, that is, the sum of the additional depreciation in respect of Y attributable to X as computed under section 1250(d)(4)(E) in (*c*) of example (1) ($7,000), plus the additional depreciation attributable to periods after Y was acquired ($2,500). Since the additional depreciation ($9,500) is less than the gain realized ($30,000, that is, $35,000 minus $5,000), the gain recognized under section 1250(a)(2) as ordinary income is $2,850, that is, 30 percent of $9,500.

(6) *Single disposition of section 1250 property and property of different class.* (i) For purposes of this subparagraph:

(*a*) Section 1250 property, section 1245 property (as defined in section 1245(a)(3)), and other property shall each be treated as a separate class of property, and

(*b*) The term *qualifying property* means property which may be acquired without recognition of gain under the applicable provision of section 1031 or 1033 (applied without regard to section 1250 or 1245) upon the disposition of property.

(ii) If upon a sale of section 1250 property gain would be recognized under section 1250(a) and if such section 1250 property together with property of a different class or classes are disposed of in one transaction in which gain is not recognized in whole or in part under section 1031 or 1033 (without regard to sections 1245 and 1250), then:

(*a*) The total amount realized shall be allocated between the different classes of property disposed of in proportion to their respective fair market values,

(*b*) The amount realized upon the disposition of property of a class shall be deemed to consist of so much of the fair market value of qualifying property of the same class acquired as is not in excess of the amount realized from the property of such class disposed of,

(*c*) The remaining portion (if any) of the amount realized upon the disposition of property of such class shall be deemed to consist of so much of the fair market value of any other property acquired as is not in excess of such remaining portion, and

(*d*) For purposes of applying (*c*) of this subdivision, the fair market value

of acquired property shall be taken into account only once and in such manner as the taxpayer determines.

(iii) The amounts determined under this subparagraph in respect of property shall apply for all purposes of the Code.

(iv) The application of this subparagraph may be illustrated by the following example:

Example: (a) Green owns property consisting of land and a fully equipped factory building thereon. The property is condemned and proceeds of $100,000 are received. If the property were sold for $100,000, gain of $40,000 would be recognized of which $10,000 would be recognized as ordinary income under section 1250(a). Proceeds of $95,000 are used to purchase property similar or related in service or use to the condemned property and under section 1033(a)(3)(A) (without regard to sections 1245 and 1250) recognition of gain is limited to $5,000. The fair market values by classes of the property disposed of, and of the property acquired, are summarized in the table below:

	Fair market value of property	
	Disposed of	Acquired
Section 1245 property	$35,000	$55,000
Section 1250 property	45,000	28,000
Land	20,000	12,000
Cash		5,000
	100,000	100,000

(*b*) The allocations under subdivision (ii) of this subparagraph are summarized in the table below:

Property disposed of	Property acquired			Cash Remaining
	Sec. 1245 Property	Sec. 1250 Property	Land	
$35,000 of section 1245 property	$35,000			
$45,000 of section 1250 property	[1] 17,000	$28,000		
$20,000 of land	[1] 3,000		$12,000	[1] $5,000
Total	55,000	28,000	12,000	5,000

[1] Determined by taxpayer pursuant to subdivision (ii)(d) of this subparagraph.

(*c*) Upon the disposition of the section 1245 property, only section 1245 property is acquired, and thus gain (if any) would not be recognized under section 1245(a)(1). See section 1245(b)(4). Upon the disposition of the section 1250 property gain under section 1250(a) would not be recognized by reason of the application of section 1250(d)(4)(A). See subparagraph (1) of this paragraph. If the gain realized on the disposition of the land is not less than $5,000, then under section 1033(a)(3)(A) the gain recognized would be $5,000, that is, an amount equal to the portion of the proceeds from the disposition of the land ($5,000) not invested in qualifying property.

(7) *Disposition of portion of property*. A disposition described in section 1250(d)(4)(A) of a portion of an item of property gives rise to an addition to capital account described in the last sentence of paragraph (d)(2)(i) of § 1.1250–5 (relating to property with 2 or more elements). If the addition to capital account is a separate improvement within the meaning of paragraph (d) of § 1.1250–5, and thus an element, then immediately after the addition is made the amount of additional depreciation for such separate improvement shall be computed under subparagraph (5) of this paragraph by treating such portion and such addition as separate properties. If the addition is not a separate improvement, then immediately after the addition is made such property is considered under paragraph (c)(5)(ii) of § 1.1250–5 as having a special element with the same amount of additional depreciation so computed. For purposes of computing applicable percentage, the holding period of the separate improvement or special element (as the case may be), which is determined under section 1250(e)(1), does not include the holding period of the property disposed of.

(e) *Sections 1071 and 1081 transactions*—(1) *General*. This paragraph prescribes regulations under section 1250(d)(5) which apply in the case of a disposition of section 1250 property in a transaction in which gain (determined without regard to section 1250) is not recognized in whole or in part by reason of the application of section 1071 (relating to gain from sale or exchange to effectuate policies of FCC) or section 1081 (relating to gain from sale or exchange in obedience to order of SEC).

(2) *Involuntary conversion treatment under section 1071.* If section 1250 property is disposed of and gain (determined without regard to section 1250) is not recognized in whole or in part solely by reason of an election under the first sentence of section 1071(a) to treat the transaction as an involuntary conversion, the consequences of the transaction shall be determined under the principles of paragraph (d) of this section.

(3) *Basis reduction under sections 1071 or 1082(a)(2).* (i) If section 1250 property is disposed of and gain (determined without regard to section 1250) is not recognized in whole or in part by reason of a reduction in basis of property pursuant to an election under section 1071(a) or the application of section 1082(a)(2), then the amount of gain taken into account by the transferor under section 1250(a) shall not exceed the sum of:

(*a*) The amount of gain recognized on such disposition (determined without regard to section 1250), plus

(*b*) In case involuntary conversion treatment was also elected under section 1071(a), an amount equal to the cost of any stock purchased in a corporation which (without regard to section 1250) would result in nonrecognition of gain under section 1033(a)(3), as modified by section 1071(a), plus

(*c*) The portion of the gain computed under section 1250(a) (without regard to this paragraph) which is neither taken into account under (*a*) or (*b*) of this subdivision nor applied under subdivision (ii) of this subparagraph to reduce the basis of section 1250 property.

(ii)(*a*) The amount of gain computed under section 1250(a) (without regard to this paragraph) which is not taken into account under subdivision (i) (*a*) or (*b*) of this subparagraph shall be applied to the amount by which the basis of the section 1250 property was reduced under section 1071(a) or 1082(a)(2), as the case may be, before other gain (which is not gain computed under section 1250(a)) is so applied.

(*b*) If the basis of more than one item of section 1250 property was so reduced, the gain applied under (*a*) of this subdivision to all such section 1250 properties shall be applied to such items in proportion to the amounts of their respective basis reductions.

(*c*) Any gain not applied under (*a*) of this subdivision shall be applied to the amount by which the basis of the nonsection 1250 property was reduced.

(iii) If gain computed under section 1250 is applied under subdivision (ii) of this subparagraph to reduce the basis of section 1250 property, the amount so applied shall be treated as additional depreciation in respect of such section 1250 property. For treatment of such section 1250 property as having a special element with additional depreciation consisting of such amount, see paragraph (c)(5)(i) of §1.1250–5. For purposes of computing applicable percentage, such special element shall have a holding period beginning on the day after the date as of which the property's basis was so reduced.

(4) *Section 1081(d)(1)(A) transaction.* No gain shall be recognized under section 1250(a) upon an exchange of property as to which gain is not recognized (without regard to section 1250) because of the application of section 1081(d)(1)(A) (relating to transfers within system group). For treatment of property in the hands of a transferee, the principles of paragraph (c)(3) of this section shall apply.

(f) *Property distributed by a partnership to a partner*—(1) *General.* For purposes of section 1250 (d)(3) and (e)(2), the basis of section 1250 property distributed by a partnership to a partner shall be determined by reference to the adjusted basis of such property to the partnership. Thus, if section 731 applies to a distribution of section 1250 property by a partnership to a partner, then even though the partner's basis is not determined for other purposes by reference to the partnership's basis, (i) the amount of gain taken into account by the partnership under section 1250(a) is limited by section 1250(d)(3) to the amount of gain recognized to the partnership upon the distribution (determined without regard to section 1250), and (ii) the holding period of the property in the hands of the partner shall, under section 1250(e)(2), include the holding period of the property in the hands of the partnership. For nonapplication of section 1250(d)(3) to a disposition to an organization (other

than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code, see paragraph (c)(1) of this section.

(2) *Treatment of property distributed by partnership.* (i) If section 1250 property is distributed by a partnership to a partner in a distribution in which no part of the partnership's *potential section 1250 income* in respect of the property was recognized as ordinary income to the partnership under paragraph (b)(2)(ii) of § 1.751–1, the additional depreciation for the property in the hands of the distributee attributable to periods before the distribution shall be an amount equal to the total potential section 1250 income of the partnership in respect of the property immediately before the distribution, recomputed as if the applicable percentage for the property had been 100 percent. Under paragraph (c)(4) of § 1.751–1, the potential section 1250 income is, in effect, the gain to which section 1250(a) would have applied if the property had been sold by the partnership immediately before the distribution at its fair market value at such time.

(ii) If upon the distribution any potential section 1250 income in respect of the property was recognized to the partnership under paragraph (b)(2)(ii) of § 1.751–1, then after the distribution the additional depreciation shall be an amount equal to (*a*) the total potential section 1250 income in respect of the property, as recomputed in subdivision (i) of this subparagraph, minus (*b*) the amount of potential section 1250 income which would have been recognized to the partnership under paragraph (b)(2)(ii) of § 1.751–1 if the applicable percentage for the property had been 100 percent.

(iii) If the partner's basis for the property immediately after the transaction exceeds the partnership's adjusted basis for the property immediately before the transaction, the excess may be an addition to capital account under paragraph (d)(2)(ii) of § 1.1250–5 (relating to property with two or more elements).

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

Example 1. (i) A partnership distributes a building to Smith on January 1, 1969, in a complete liquidation of his partnership interest to which section 736(a) does not apply. On the date of the distribution, the partnership's holding period for the property is 40 full months and, accordingly, the applicable percentage under section 1250(a)(2) is 80 percent. On such date, the partnership's additional depreciation for the building ($6,250) is lower than the excess ($40,000) of its fair market value ($140,000) over adjusted basis ($100,000). Thus, under paragraph (c)(4) of § 1.751–1, the partnership's potential section 1250 income in respect of the building is $5,000 (80 percent of $6,250). Assume that section 751(b) does not apply to the distribution. Accordingly, no gain would be recognized to the partnership under section 731(b) (without regard to the application of section 1250). Smith's basis for his partnership interest was $150,000, and under section 732(b) Smith's basis for the building is equal to his basis for his partnership interest. Thus, Smith's basis for the building is not determined by reference to the partnership's basis for the building. Nevertheless, under subparagraph (1) of this paragraph, no gain is recognized to the partnership under section 1250(a)(2) and Smith's holding period for the property includes the partnership's holding period.

(ii) Six full months after Smith received the building in the distribution, or July 1, 1969, he sells it for $153,000. Assume that no depreciation was allowed or allowable to Smith for the building, and that the special rules under § 1.1250–5 for property with two or more elements do not apply. Since Smith's holding period for the building includes its holding period in the hands of the partnership, his holding period is 46 full months (40 full months for the partnership plus 6 full months for Smith) and the applicable percentage under section 1250(a)(2) is 74 percent.

(iii) Since no potential section 1250 income was recognized to the partnership under paragraph (b)(2)(ii) of § 1.751–1, the additional depreciation for the building attributable to periods before the distribution is determined under the provisions of subparagraph (2)(i) of this paragraph. Under such provisions, the potential section 1250 income to the partnership, which was actually $5,000 (that is, 80 percent of $6,250), is recomputed as if the applicable percentage were 100 percent, and thus such additional depreciation is $6,250 (that is, 100 percent of $6,250). Since no depreciation was allowed or allowable for the building in Smith's hands, the additional depreciation for the building attributable to Smith's total holding period (46 full months) is $6,250. Since the gain realized ($3,000, that is, amount realized, $153,000, minus adjusted basis, $150,000), is lower than the additional depreciation ($6,250), the gain recognized to Smith under section 1250(a)(2) is $2,220 (that is, 74 percent of $3,000).

Example 2. Assume the facts as in example (1) except that as a result of the distribution the partnership recognizes under paragraph (b)(2)(ii) of § 1.751–1 potential section 1250 income of $1,000 (that is, 80 percent of $1,250). The additional depreciation attributable to periods before the distribution, as determined under the provisions of subparagraph (2)(ii) of this paragraph, is $5,000, that is, (*a*) the total potential section 1250 income in respect of the property, recomputed in example (1) as if the applicable percentage were 100 percent ($6,250), minus (*b*) the amount of potential section 1250 income which would have been recognized to the partnership under paragraph (b)(2)(ii) of § 1.751–1 if the applicable percentage for the property had been 100 percent ($1,250, that is, 100 percent of $1,250).

(4) *Treatment of partnership property after certain transactions.* If under paragraph (b)(3) of § 1.751–1 (relating to certain distributions of partnership property other than section 751 property treated as sales or exchanges) a partnership is treated as purchasing section 1250 property (or a portion thereof) from a distributee who relinquishes his interest in such property (or portion), then after the date of such purchase the following rules shall apply:

(i) If only a portion of the property is treated as purchased, there shall be excluded from the additional depreciation for the remaining portion any additional depreciation in respect of the purchased portion for periods before such purchase.

(ii) In respect of the purchased property (or portion), (*a*) as of the date of purchase the amount of additional depreciation shall be zero, and (*b*) for purposes of computing applicable percentage the holding period shall begin on the day after the date of such purchase.

(5) *Cross reference.* See paragraph (f) of § 1.1250–1 for the amount of additional depreciation for partnership property in respect of a partner who acquired his partnership interest in certain transactions when an election under section 754 (relating to optional adjustments to basis of partnership property) was in effect.

(g) *Disposition of principal residence*—(1) *In general.* (i) Section 1250(d)(7)(A) provides that section 1250(a) shall not apply to a disposition of property by a taxpayer to the extent the property is used by the taxpayer as his principal residence (within the meaning of section 1034(a) and the regulations thereunder, relating to a sale or exchange of residence). Thus, for example, if a doctor sells a house, of which one portion was used as his principal residence within the meaning of section 1034(a) and the other portion was properly subject to the allowance for depreciation as property used in his trade or business, then, by reason of the application of section 1250(d)(7)(A), section 1250(a) does not apply in respect of the disposition of the portion used as his principal residence. The provisions of this subparagraph shall apply regardless of whether section 1034 applies. Thus, for example, if section 1034 did not apply to the sale because the doctor did not invest in a new principal residence within the period specified in section 1034, nevertheless section 1250(a) would not apply to the disposition of the portion used as a principal residence.

(ii) Section 1250(d)(7)(B) provides that section 1250(a) shall not apply to a disposition of section 1250 property by a taxpayer who, in respect of the property, satisfies the age and ownership requirements of section 121 (relating to exclusion from gross income of gain on sale or exchange of residence of individual who has attained age 65), but only to the extent the taxpayer satisfies the use requirements of section 121 in respect of such property. Thus, if a taxpayer has attained the age of 65 before the date on which he disposes of section 1250 property, and if during the 8-year period ending on the date of the disposition the property has been owned and used by the taxpayer solely as his principal residence for periods aggregating 5 years or more, then section 1250(a) does not apply in respect to the disposition. This result would not be changed even if the taxpayer does not or cannot make the election provided for in section 121 and even if section 121 applies to only a portion of the gain because the adjusted sales price exceeds the $20,000 limitation in section 121(b)(1). If, however, only a portion of the property has been used as his principal residence for such periods aggregating 5 years or more, then, by reason of the application of section 1250(d)(7)(B), section 1250(a) is inapplicable only to the portion so used. For special rules for determining whether

the age, ownership, and use requirements of section 121 are treated as satisfied, and for the manner of applying such requirements, see section 121(d) and the regulations thereunder.

(2) *Concurrent operation of section 1250(d)(7) with other provisions.* Upon the disposition of a principal residence, gain computed under section 1250(a) may not be recognized in whole or in part by reason of the application of both the provisions of section 1250(d)(7) and the provisions of one of the other exceptions or limitations enumerated in section 1250(d). Thus, for example, if an entire house is transferred as a gift, and if section 1250(d)(7) applies to only a portion of the house, then section 1250(d)(1) excepts the disposition of the entire house from the application of section 1250(a).

(3) *Special rule.* If by reason of section 1250(d)(7) a disposition is partially excepted from the application of section 1250(a), and if no other paragraph of section 1250(d) excepts the disposition entirely from such application, then the gain to which section 1250(a) applies shall be an amount which bears the same ratio to (i) the gain computed under section 1250(a) (without regard to section 1250(d)(7)), as (ii) the fair market value of the portion of the property to which the exception in section 1250(d)(7) does not apply, bears to (iii) the total fair market value of the property. Thus, for example, if under paragraph (a)(2) of this section gain of $300 would be recognized as ordinary income under section 1250(a) (without regard to section 1250(d)(7)) upon a combined sale and gift of section 1250 property, and if the property has a fair market value of $25,000 of which $10,000 is properly allocable to a portion not used as a principal residence, then the amount of gain recognized as ordinary income under section 1250(a) would be $120 (10/25 of $300).

(4) *Treatment of property in hands of transferee.* If property is disposed of in a transaction to which section 1250(d)(7) applies, and if its basis in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 1250(d)(1) (relating to gifts) or section 1250(d)(3) (relating to certain tax-free transactions), then the treatment of the property in the hands of the transferee shall be determined under paragraph (a)(3) or (c)(3) (whichever is applicable) of this section

(5) *Treatment of property acquired in like kind exchange or involuntary conversion.* If property is disposed of in a transaction to which section 1250(d)(7) (relating to principal residence) and section 1250(d)(4) (relating to like kind exchanges and involuntary conversions) apply, then:

(i) The basis of the property acquired shall be determined under the applicable provisions of paragraph (d) (2), (3), or (4) of this section, applied as if all gain computed under section 1250(a) (except any gain not recognized solely by reason of the application of section 1250(d)(7)) were not taken into account by reason of section 1250(d)(4)(A),

(ii) The additional depreciation for the property acquired shall be determined in the manner prescribed in paragraph (d)(5) of this section, so applied, and

(iii) For purposes of computing the applicable percentage, the holding period of the acquired property shall be determined under section 1250(e)(1).

(6) *Treatment of property acquired in section 1034 transaction.* If a principal residence is disposed of in a transaction to which section 1250(d)(7) applies, and if by reason of the application of section 1034 (relating to sale or exchange of residence) the basis of property acquired in the transaction is determined by reference to the basis in the hands of the taxpayer of the property disposed of, then:

(i) The additional depreciation for the acquired property immediately after the transaction shall be an amount equal to (*a*) the amount of the additional depreciation for the property disposed of, minus (*b*) the amount of any gain which would have been taken into account under section 1250(a) by the transferor upon the disposition if the applicable percentage for the property had been 100 percent,

(ii) For purposes of computing the applicable percentage, the holding period of the acquired property includes the holding period of the disposed of property (see section 1250(e)(3)),

(iii) If the adjusted basis of the acquired property exceeds the adjusted

basis immediately before the transfer of the property disposed of, the excess is an addition to capital account under paragraph (d)(2)(ii) of § 1.1250–5 (relating to property with more than one element), and

(iv) If the property disposed of consisted of two or more elements within the meaning of paragraph (c) of § 1.1250–5, see paragraph (e)(3) of § 1.1250–5 for the amount of additional depreciation and the holding period for each element in the hands of the transferee.

(h) *Limitation for disposition of qualified low-income housing*—(1) *Limitation on gain*. (i) Under section 1250(d)(8)(A), if section 1250 property is disposed of and gain (determined without regard to section 1250) is not recognized in whole or in part under section 1039 (relating to certain sales of low-income housing projects), then the amount of gain recognized by the transferor under section 1250(a) shall not exceed the greater of:

(*a*) The amount of gain recognized under section 1039 (determined without regard to section 1250), or

(*b*) The excess, if any, of the amount of gain which would, but for section 1250(d)(8)(A), be taken into account under section 1250(a), over the cost of the section 1250 property acquired in the transaction.

For purposes of this paragraph the term *qualified housing project, approved disposition, reinvestment period*, and *net amount realized* shall have the same meaning as in section 1039 and § 1.1039–1.

(ii) The principles of this subparagraph may be illustrated by the following examples:

Example 1. (i) Taxpayer A owns a qualified housing project and makes an approved disposition of the project on January 1, 1971. The net amount realized upon the disposition is $550,000, of which $475,000 is attributable to section 1250 property. The adjusted basis of the section 1250 property is $250,000 and the gain realized on the disposition of section 1250 property is $225,000. The additional depreciation for the property is $100,000, the applicable percentage is 48 percent, and if section 1250(d)(8)(A) did not apply to the disposition, $48,000 of gain would be recognized under section 1250(a). Within the reinvestment period, A purchases a replacement qualified housing project at a cost of $525,000, of which $425,000 is attributable to section 1250 property. A properly elects under section 1039(a) and the regulations thereunder to limit the recognition of gain (determined without regard to section 1250) to $25,000, that is, the excess of the net amount realized ($550,000) over the cost of the replacement housing project ($525,000).

(ii) The amount of gain recognized under section 1250(a) is limited to $25,000, that is, the greater of (*a*) the amount of gain recognized without regard to section 1250(a) ($25,000), or (*b*) the excess of (*1*) the amount of gain which would be taken into account under section 1250(a) if section 1250(d)(8)(A) did not apply ($225,000), over (*2*) the cost of the replacement section 1250 property ($425,000), or zero.

Example 2. The facts are the same as in example (1) except that only $180,000 of the cost of the replacement housing project is attributable to section 1250 property. Thus, the gain recognized under section 1250(a) is limited to $45,000, the greater of (*a*) the excess of (*1*) the amount of gain which would be taken into account under section 1250(a) if section 1250(d)(8)(A) did not apply ($225,000), over (*2*) the cost of the replacement section 1250 property ($180,000), or (*b*) the amount of gain recognized without regard to section 1250 ($25,000).

(2) *Replacement project consisting of more than one element*. (i) If (*a*) section 1250 property is disposed of, (*b*) any portion of the gain which would have been recognized under section 1250(a) is not recognized by reason of section 1250(d)(8)(A), and (*c*) the cost of the replacement section 1250 property constructed, reconstructed, or acquired during the reinvestment period exceeds the net amount realized attributable to the section 1250 property disposed of, then the section 1250 property shall consist of two elements. For purposes of this paragraph, the *reinvestment element* is that portion of the section 1250 property constructed, reconstructed, or acquired during the reinvestment period the cost of which does not exceed the net amount realized attributable to the section 1250 property disposed of, reduced by any gain recognized with respect to such property. The *additional cost element* is that portion of the section 1250 property constructed, reconstructed, or acquired during the reinvestment period whose cost exceeds the net amount realized attributable to the section 1250 property disposed of.

(ii) The principles of this subparagraph may be illustrated by the following example:

Example 1. (i) Taxpayer B disposes of a qualified housing project consisting of section 1250 property with an adjusted basis of $500,000 and land with a basis of $100,000. The amount realized on the disposition is $750,000 of which $650,000 is attributable to the section 1250 property. B constructs a replacement housing project at a cost of $1,000,000 of which $850,000 is attributable to section 1250 property. B elects in accordance with the provisions of section 1039(a) and the regulations there under not to recognize the $150,000 gain realized.

(ii) Under section 1250(d)(8)(A) no gain is recognized under section 1250(a). The replacement section 1250 property consists of the two elements. The reinvestment element has a cost of $650,000, i.e., that portion of the replacement section 1250 property the cost of which does not exceed the amount realized attributable to the section 1250 property disposed of ($650,000), reduced by any gain recognized with respect to such property (zero). The additional cost element has a cost of $200,000, that is, the excess of the cost of the replacement section 1250 property ($850,000) over the amount realized attributable to the section 1250 property disposed of ($650,000).

(3) *Basis of property acquired.* (i) If section 1250 property is disposed of and gain (determined without regard to section 1250) is not recognized in whole or in part under section 1039 (relating to certain sales of low-income housing projects), then the basis of the section 1250 property and other property acquired in the transaction shall be determined in accordance with the rules of this subparagraph. Generally, the basis of the property acquired in a transaction to which section 1039(a) applies is its cost reduced by the amount of any gain not recognized attributable to the property disposed of (see section 1039(d)). In a case where the replacement section 1250 property constructed, reconstructed, or acquired within the reinvestment period is treated as consisting of more than one element under section 1250(d)(8)(e), the aggregate basis of the property determined under section 1039(d) shall be allocated as follows: first, to the reinvestment element of the section 1250 property, in an amount equal to the amount determined under section 1250(d)(8)(E)(i) reduced by the amount of any gain not recognized attributable to the section 1250 property disposed of; second, to the other replacement property (other than section 1250 property) in an amount equal to the amount of its cost reduced (but not below zero) by any remaining amount of gain not recognized; and finally, to the additional cost element of the section 1250 property, in an amount equal to the amount determined under section 1250(d)(8)(E)(ii) reduced by any amount of gain not recognized which has not been taken into account in determining the basis of the reinvestment element and the other replacement property that is not section 1250 property. See paragraph (h)(2) of this section for definition of the terms *reinvestment element* and *additional cost element.*

(ii) The principles of this subparagraph may be illustrated by the following examples:

Example 1. The facts are the same as in example (1) of subparagraph (1)(ii) of this paragraph. The basis of the replacement section 1250 property is $225,000, the amount of the reinvestment element ($425,000) minus the gain not recognized attributable to the section 1250 property disposed of ($200,000).

Example 2. Taxpayer C disposes of a qualified housing project on January 1, 1971. The adjusted basis for the project is $3,800,000, of which $3,000,000 is attributable to section 1250 property and $800,000 is attributable to land. The amount realized on the disposition is $5,000,000, of which $4,000,000 is attributable to the section 1250 property and $1,000,000 is attributable to the land. The gain realized upon the disposition is $1,200,000, that is, amount realized ($5,000,000) minus adjusted basis ($3,800,000), of which $1,000,000 is attributable to the section 1250 property disposed of. Within the reinvestment period, C purchases another qualified housing project at a cost of $5,500,000, of which $4,000,000 is attributable to section 1250 property and $1,500,000 is attributable to other property. C makes an election under section 1039(a) and the regulations thereunder and none of the $1,200,000 gain realized on the disposition is recognized (determined without regard to section 1250). Under section 1250(d)(8)(A), none of the gain realized is recognized under section 1250(a). The basis of the replacement section 1250 property is $3,000,000, that is, the amount of the reinvestment element ($4,000,000) less the amount of gain not recognized attributable to section 1250 property disposed of ($1,000,000). The basis of the other property acquired is $1,300,000, that is, its cost ($1,500,000) reduced by the remaining gain not recognized ($200,000).

Example 3. The facts are the same as in example (2) except that the cost of the replacement section 1250 property is $4,500,000 and the cost of the other property is $1,000,000. Thus, the replacement section 1250 property

consists of two elements under section 1250(d)(8)(E). The reinvestment element (section 1250(d)(8)(E)(i)) has a basis of $3,000,000, that is $4,000,000 (that portion of the section 1250 property acquired the cost of which does not exceed the net amount realized attributable to the section 1250 property disposed of), reduced by $1,000,000 (the gain not recognized attributable to the section 1250 property disposed of). The basis of the other property is $800,000, that is, its cost ($1,000,000) reduced by the remaining gain not recognized ($200,000). The additional cost element (section 1250(d)(8)(E)(ii)) has a basis of $500,000, that is, the portion of the section 1250 property acquired the cost of which exceeds the net amount realized attributable to the section 1250 property disposed of. This amount ($500,000) is not reduced by any amount of gain not recognized because all of the gain not recognized has already been taken into account in determining the basis of the reinvestment element and the other replacement property that is not section 1250 property.

(4) *Additional depreciation for property acquired.* (i) If a qualified housing project is disposed of in a transaction to which section 1039(a) applies, the additional depreciation for the replacement property immediately after the transaction shall be an amount equal to (*a*) the amount of additional depreciation for the property disposed of, minus (*b*) the amount of additional depreciation necessary to produce the amount of gain recognized under section 1250(a). Thus, if no gain is recognized upon a disposition of a qualified housing project, the additional depreciation for the property acquired will be the same as for the property disposed of. On the other hand, if upon disposition of a project, gain of $40,000 was recognized under section 1250(a), and if the additional depreciation for the project and the applicable percentage were $100,000 and 80 percent, respectively, the additional depreciation for the replacement housing project would be $50,000, that is, $100,000 minus $50,000, the amount of additional depreciation necessary to produce $40,000 of recognized gain where the applicable percentage is 80 percent.

(ii) If the property acquired in the transaction consists of more than one element of section 1250 property by reason of section 1250(d)(8)(E), the additional depreciation under subdivision (i) of this subparagraph shall be allocated solely to the reinvestment element.

(5) *Additional limitation.* If, in a transaction to which section 1039(a) applies, gain is recognized by the taxpayer, the amount of gain recognized which is attributable to section 1250 property disposed of is, under section 1250(d)(8)(F)(i), limited to an amount equal to the net amount realized attributable to the section 1250 property disposed of reduced by the greater of (i) the adjusted basis of the section 1250 property disposed of, or (ii) the cost of the section 1250 property acquired. The limitation of section 1250(d)(8)(F)(i) may be illustrated by the following example:

Example: Taxpayer D owns property constituting a qualified housing project under section 1039(b)(1). In an approved disposition, the project is sold for $225,000. The net amount realized on the disposition is $225,000 of which $175,000 is attributable to the section 1250 property disposed of. The adjusted basis of such property is $150,000 and thus the gain realized upon the disposition of the section 1250 property is $25,000. Assume that the total gain realized upon disposition of the project is $45,000. Within the reinvestment period, D purchases another qualified housing project at a cost of $200,000, of which $160,000 is attributable to section 1250 property. D elects, in accordance with section 1039(a) and the regulations thereunder, to limit the recognition of gain to $25,000, that is, the net amount realized ($225,000), minus the cost of the replacement housing project ($200,000). Under this subparagraph, $15,000 of the $25,000 gain recognized is attributable to the section 1250 property disposed of, that is, the net amount realized attributable to the section 1250 property disposed of ($175,000), reduced by $160,000, the greater of the adjusted basis of the section 1250 property disposed of ($150,000) or the cost of the section 1250 property acquired ($160,000).

(6) *Allocation rule.* (i) If, in a transaction to which paragraph (h)(1) of this section applies, the section 1250 property disposed of is treated as consisting of more than one element by reason of the application of section 1250(d)(8)(E) with respect to a prior transaction, then the amount of gain recognized, the net amount realized, and the additional depreciation with respect to each such element shall be allocated to the elements of the replacement section 1250 property in accordance with the provisions of this subparagraph.

(ii) The portion of the net amount realized upon such a disposition which shall be allocated to each element of the section 1250 property disposed of is that amount which bears the same ratio to the net amount realized attributable to all the section 1250 property disposed of in the transaction as the additional depreciation for that element bears to the total additional depreciation for all elements disposed of. If any gain is recognized upon disposition of the section 1250 property, such gain shall be allocated to each element in the same proportion as the gain realized for that element bears to the gain realized for all elements disposed of. The additional depreciation for each reinvestment element of the replacement section 1250 property shall be the same as for the corresponding element of the property disposed of, decreased by the amount of additional depreciation necessary to produce the amount of gain recognized for such element. The additional depreciation for any additional cost element shall be zero.

(iii) The principles of this subparagraph may be illustrated by the following example:

Example: Taxpayer E disposes of a qualified housing project in an approved disposition. The net amount realized is $1,090,000 of which $900,000 is attributable to section 1250 property. The section 1250 property consists of (1) a reinvestment element with an adjusted basis of $300,000, additional depreciation of $100,000, and an applicable percentage of 50 percent, and (2) an additional cost element with an adjusted basis of $200,000, additional depreciation of $50,000, and an applicable percentage of 80 percent. Gain of $400,000 is realized on the disposition of the section 1250 property, that is, amount realized ($900,000) minus adjusted basis ($500,000). Within the reinvestment period, E purchases another qualified housing project at a cost of $1,000,000 of which $840,000 is attributable to section 1250 property. E elects, in accordance with section 1039 and the regulations thereunder, to limit recognition of gain (determined without regard to section 1250) to $90,000, that is, the excess of the net amount realized ($1,090,000) over the cost of the replacement project ($1,000,000). Under section 1250(d)(8)(A), the amount of gain recognized under section 1250(a) is limited to $90,000 (see subparagraph (1) of this paragraph). Under section 1250(d)(8)(F)(ii) and this subparagraph, $600,000 of the $900,000 net amount realized attributable to the section 1250 property is allocated to the reinvestment element, that is, additional depreciation for the element ($100,000) over total additional depreciation ($150,000) times the net amount realized ($900,000). The remaining $300,000 is allocated to the additional cost element. Thus, the gain realized attributable to the reinvestment element is $300,000, that is, net amount realized ($600,000) minus adjusted basis ($300,000). The gain realized attributable to the additional cost element is $100,000, that is, net amount realized ($300,000) minus adjusted basis ($200,000). Under subparagraph (5) of this paragraph, the gain recognized attributable to the section 1250 property is limited to $60,000, that is, the net amount realized attributable to the section 1250 property disposed of ($900,000) minus the greater of the adjusted basis of such property ($500,000) or the cost of the section 1250 property acquired in the transaction ($840,000). Under section 1250(d)(8)(F)(ii) and this subparagraph, $45,000 of the $60,000 gain recognized is attributable to the reinvestment element, that is, $60,000 multiplied by a fraction whose numerator is the gain realized attributable to the reinvestment element ($300,000) and whose denominator is the total gain realized attributable to all the section 1250 property ($400,000). The remaining $15,000 of the gain recognized is attributable to the additional cost element. The new property acquired has no additional cost element. The reinvestment element of the new property acquired consists of 2 subelements corresponding to the reinvestment element and additional cost element of the property disposed of. The subelement corresponding to the reinvestment element has additional depreciation of $10,000, that is, its additional depreciation immediately before the disposition ($100,000), minus $90,000, the amount of additional depreciation necessary to produce $45,000 of section 1250(a) gain where the applicable percentage is 50 percent. The subelement corresponding to the additional cost element has additional depreciation of $31,250, that is, its additional depreciation immediately before the disposition ($50,000), minus $18,750, the amount of additional depreciation necessary to produce $15,000 of section 1250(a) gain where the applicable percentage is 80 percent.

[T.D. 7084, 36 FR 275, Jan. 8, 1971, as amended by T.D. 7193, 37 FR 12957, June 30, 1972; T.D. 7400, 41 FR 5101, Feb. 4, 1976; 41 FR 7095, Feb. 17, 1976]

§ 1.1250–4 Holding period.

(a) *General.* In general, for purposes only of determining the applicable percentage (as defined in section 1250 (1)(C) and (2)(B)) of section 1250 property, the holding period of the property shall be determined under the rules of

section 1250(e) and this section and not under the rules of section 1223. If the property is treated as consisting of two or more elements (within the meaning of paragraph (c)(1) of § 1.1250–5), see paragraph (a)(2)(ii) of § 1.1250–5 for application of this section to determination of holding period of each element. Section 1250(e) does not affect the determination of the amount of additional depreciation in respect of section 1250 property.

(b) *Beginning of holding period.* (1) For the purpose of determining the applicable percentage, in the case of property acquired by the taxpayer (other than by means of a transaction referred to in paragraph (c) or (d) of this section), the holding period of the property shall begin on the day after the date of its acquisition. See section 1250(e)(1)(A). Thus, for example, if a taxpayer purchases section 1250 property on January 1, 1965, the holding period of the property begins on January 2, 1965. If he sells the property on October 1, 1966, the holding period on the day of the sale is 21 full months, and, accordingly, the applicable percentage is 99 percent. This result would not be changed even if the property initially had been used solely as the taxpayer's residence for a portion of the 21-month period. If, however, the property were sold on September 30, 1966, the holding period would be only 20 full months.

(2) For the purpose of determining the applicable percentage in the case of property constructed, reconstructed, or erected by the taxpayer, the holding period of the property shall begin on the first day of the month during which the property is placed in service. See section 1250(e)(1)(B). Thus, for example, if a taxpayer constructs section 1250 property and places it in service on January 15, 1965, its holding period begins on January 1, 1965. If the taxpayer sells the property on December 31, 1966, its holding period on the day of sale is 24 full months, and, accordingly, the applicable percentage is 96 percent. For purposes of this subparagraph, property is placed in service on the date on which it is first used, whether in a trade or business, in the production of income, or in a personal activity. Thus, for example, a residence constructed by a taxpayer for his personal use is placed in service on the date it is occupied as a residence. For purposes of determining the date property is placed in service, it is immaterial when the period begins for depreciation with respect to the property under any depreciation practice under which depreciation begins in any month other than the month in which the property is placed in service. If one or more units of a single property are placed in service on different dates before the completion of the property, see paragraph (c)(3) of § 1.1250–5 (relating to treatment of each such unit as an element).

(c) *Property with transferred basis.* Under section 1250(e)(2), if the basis of property acquired in a transaction described in this subparagraph is determined by reference to its basis in the hands of the transferor, then the holding period of the property in the hands of the transferee shall include the holding period of the property in the hands of the transferor. The transactions described in this subparagraph are:

(1) A gift described in section 1250(d)(1).

(2) Certain transfers at death to the extent provided in paragraph (b)(2)(ii) of § 1.1250–3.

(3) Certain tax-free transactions to which section 1250(d)(3) applies. For application of section 1250 (d)(3) and (e)(2) to a distribution by a partnership to a partner, see paragraph (f)(1) of § 1.1250–3.

(4) A transfer described in paragraph (e)(4) of § 1.1250–3 (relating to transaction under section 1081(d)(1)(A)).

(5) A transfer at death where the basis of the property in the hands of the transferee is determined under section 1022.

(d) *Principal residence acquired in certain transactions.* The holding period of a principal residence acquired in a transaction to which section 1034 and paragraph (g)(6) of § 1.1250–3 apply includes the holding period of the principal residence disposed of in such transaction. See section 1250(e)(3). The holding period of a principal residence acquired does not include the period beginning on the day after the date of the disposition and ending on the date of the acquisition.

(e) *Application of transferred basis and principal residence rules.* The determination of holding period under this section shall be made without regard to whether a transaction occurred prior to the effective date of section 1250 and without regard to whether there was any gain upon the transaction. Thus, for example, under paragraph (c) of this section a donee's holding period for property includes his donor's holding period notwithstanding that the gift occurred on or before December 31, 1963, or that there was no additional depreciation in respect of the property at the time of the gift.

(f) *Qualified low-income housing project acquired in certain transactions.* The holding period of a *reinvestment element* (and of subelements thereof) of section 1250 property (as defined in paragraph (h) (2) of § 1.1250–3) acquired in a transaction to which sections 1039(a) and 1250(d)(8)(A) apply includes the holding period of the corresponding element of the section 1250 property disposed of. See section 1250(e)(4). The holding period of the *additional cost element* (as defined in paragraph (h)(2) of § 1.1250–3) begins on the date the replacement project is acquired. The holding period of a *reinvestment element* of section 1250 property does not include the period beginning on the day after the date of the disposition and ending (1) on the date of the acquisition of the replacement housing project, or (2) on the date the replacement housing project constructed or reconstructed by the taxpayer is placed in service.

(g) *Cross reference.* If the adjusted basis of the property in the hands of the transferee immediately after a transaction to which paragraph (c) or (d) of this section applies exceeds its adjusted basis in the hands of the transferor immediately before the transaction, the excess is an addition to capital account under paragraph (d)(2)(ii) of § 1.1250–5 (relating to property with two or more elements).

(h) *Effective/applicability date.* This section applies on and after January 19, 2017. For rules before January 19, 2017, see § 1.1250–4 as contained in 26 CFR part 1 revised as of April 1, 2016.

[T.D. 7084, 36 FR 281, Jan. 8, 1971, as amended by T.D. 7400, 41 FR 5103, Feb. 4, 1976; T.D. 9811, 82 FR 6241, Jan. 19, 2017]

§ 1.1250–5 Property with two or more elements.

(a) *Dispositions before January 1, 1970*—(1) *Amount treated as ordinary income.* If section 1250 property consisting of two or more elements (described in paragraph (c) of this section) is disposed of before January 1, 1970, the amount of gain taken into account under section 1250(a)(2) shall be the sum, determined in three steps under subparagraphs (2), (3), and (4) of this paragraph, of the amounts of gain for each element.

(2) *Step 1.* The first step is to make the following computations:

(i) In respect of the property as a whole, compute the additional depreciation (as defined in section 1250(b)), and the gain realized. For purposes of this paragraph, in the case of a transaction other than a sale, exchange or involuntary conversion, the gain realized shall be considered to be the excess of the fair market value of the property over its adjusted basis.

(ii) In respect of each element as if it were a separate property, compute the additional depreciation for the element, and the applicable percentage (as defined in section 1250(a)(2)) for the element. For additional depreciation in respect of an element of property acquired in certain transactions, see paragraph (e) of this section. For purposes of determining additional depreciation, the holding period of an element shall be determined under section 1223, applied by treating the element as a separate property. However, for the purpose of determining applicable percentage, the holding period for an element shall, except to the extent provided in paragraphs (c)(5), (e), and (f) of this section, be determined in accordance with the rules prescribed in § 1.1250–4.

(3) *Step 2.* The second step is to determine the amount of gain for each element in the following manner:

(i) If the amount of additional depreciation in respect of the property as a whole is equal to the sum of the additional depreciation in respect of each element having additional depreciation, and if such amount is not more than the gain realized, then the amount of gain to be taken into account for an element is the product of

the additional depreciation for the element, multiplied by the applicable percentage for the element.

(ii) If subdivision (i) of this subparagraph does not apply, the amount of gain to be taken into account for an element is the product of:

(*a*) The additional depreciation for the element, multiplied by

(*b*) The applicable percentage for the element, and multiplied by

(*c*) A ratio, computed by dividing (*1*) the lower of the additional depreciation in respect of the property as a whole or the gain realized, by (*2*) the sum of the additional depreciation in respect of each element having additional depreciation.

(4) *Step 3*. The third step is to compute the sum of the amounts of gain for each element, as determined in step 2.

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

Example 1. Gain of $35,000 is realized upon a sale, before January 1, 1970, of section 1250 property which consists of four elements (W, X, Y, and Z). Since on the date of the sale the amount of additional depreciation in respect of the property as a whole ($24,000) is equal to the sum of the additional depreciation in respect of each element having additional depreciation and is less than the gain realized, the additional depreciation for each element is determined under subparagraph (3)(i) of this paragraph. The amount of gain taken into account under section. 1250(a)(2) is $7,500, as determined in the following table in accordance with the additional facts assumed.

Element	Additional depreciation ×	Applicable percentage=	Gain for element
W	$12,000 ×	0=	0
X	6,000 ×	50=	$3,000
Y	0 ×	63=	0
Z	6,000 ×	75=	4,500
Totals	24,000		7,500

Example 2. Assume the same facts as in example (1), except that in respect of the property as a whole the additional depreciation is $20,000 because with respect to element Y additional depreciation allowed was $4,000 less than straight line. Accordingly, the sum of the additional depreciation for each element having additional depreciation is $24,000, that is, $4,000 greater than the additional depreciation in respect of the property as a whole. Thus, the additional depreciation for each element is determined under subparagraph (3)(ii) of this paragraph. The ratio referred to in subparagraph (3)(ii)(c) of this paragraph is twenty twenty-fourths, that is, the lower of additional depreciation in respect of the property as a whole ($20,000) or the gain realized ($35,000), divided by the sum of the additional depreciation in respect of each element having additional depreciation ($24,000). The amount of gain taken into account under section 1250(a)(2) is $6,250, as determined in the following table:

Element	Additional depreciation ×	Applicable percentage ×	Ratio=	Gain for element
W	$12,000 ×	0 ×	20:24=	0
X	6,000 ×	50 ×	20:24=	$2,500
Y	0 ×	63 ×	20:24=	0
Z	6,000 ×	75 ×	20:24=	3,750
Totals	24,000			6,250

(b) *Dispositions after December 31, 1969*—(1) *Amount treated as ordinary income*. If section 1250 property consisting of two or more elements (described in paragraph (c) of this section) is disposed of after December 31, 1969, the amount of gain taken into account under section 1250(a) shall be the sum, determined in 5 steps under subparagraphs (2), (3), (4), (5), and (6) of this paragraph, of the amount of gain for each element. Steps 3 and 4 are used only if the gain realized exceeds the additional depreciation attributable to periods after December 31, 1969, in respect of the property as a whole.

(2) *Step 1*. The first step is to make the following computations:

(i) In respect of the property as a whole, compute the additional depreciation (as defined in section 1250(b)) attributable to periods after December 31, 1969, and the gain realized. For purposes of this paragraph, in the case of a transaction other than a sale, exchange, or involuntary conversion, the gain realized shall be considered to be the excess of the fair market value of the property over its adjusted basis.

(ii) In respect of each element as if it were a separate property, compute the additional depreciation for the element attributable to periods after December 31, 1969, and the applicable percentage (as defined in section 1250(a)(1)) for the element. For additional depreciation in respect of an element of property acquired in certain transactions, see

paragraph (e) of this section. For purposes of determining additional depreciation, the holding period of an element shall be determined under section 1223, applied by treating the element as a separate property. However, for the purpose of determining applicable percentage, the holding period for an element shall, except to the extent provided in paragraphs (c)(5), (e), and (f) of this section, be determined in accordance with the rules prescribed in § 1.1250–4.

(3) *Step 2.* The second step is to determine the amount of gain recognized for each element under section 1250(a) (1) in the following manner:

(i) If the amount of additional depreciation in respect of the property as a whole attributable to periods after December 31, 1969, is equal to the sum of the additional depreciation in respect of each element having such additional depreciation, and if such amount is not more than the gain realized, then the amount of gain to be taken into account for an element under section 1250(a)(1) is the product of the additional depreciation attributable to periods after December 31, 1960, for the element, multiplied by the applicable percentage for the element determined under section 1250(a)(1).

(ii) If subdivision (i) of this subparagraph does not apply, the amount of gain to be taken into account under section 1250(a)(1) for an element is the product of:

(*a*) The additional depreciation attributable to periods after December 31, 1969, for the element multiplied by

(*b*) The applicable percentage for the element determined under section 1250(a)(1) for the element, and multiplied by

(*c*) A ratio, computed by dividing (*1*) the lower of the additional depreciation in respect of the property as a whole which is attributable to periods after December 31, 1969, or the gain realized, by (*2*) the sum of the additional depreciation attributable to periods after December 31, 1969, in respect of each element having such additional depreciation.

(4) *Step (3).* If the gain realized exceeds the additional depreciation in respect of the property as a whole attributable to periods after December 31, 1969.

(i) Compute the additional depreciation attributable to periods before January 1, 1970, and the remaining gain (or remaining potential gain in the case of a transaction other than a sale, exchange, or involuntary conversion), in respect of the property as a whole.

(ii) Compute the additional depreciation attributable to periods before January 1, 1970, and the applicable percentage determined under section 1250(a)(2) in respect of each element as if it were a separate property. For additional depreciation in respect of an element of property acquired in certain transactions, see paragraph (e) of this section. For purposes of determining additional depreciation, the holding period of an element shall be determined under section 1223, applied by treating the element as a separate property. However, for the purpose of determining applicable percentage, the holding period of an element shall, except to the extent provided in paragraphs (c)(5), (e), and (f) of this section, be determined in accordance with the rules prescribed in § 1.1250–4.

(5) *Step (4).* The fourth step is to compute the gain recognized under section 1250(a)(2) for each element (if computation was required under step (3)) in the following manner:

(i) If the amount of additional depreciation in respect of the property as a whole attributable to periods before January 1, 1970, is equal to the sum of the additional depreciation in respect of each element having such additional depreciation, and if such amount is not more than the remaining gain (or remaining potential gain), then the amount of gain to be taken into account for an element under section 1250(a)(2) is the product of the additional depreciation attributable to periods before January 1, 1970, for the element, multiplied by the applicable percentage determined under section 1250(a)(2) for the element.

(ii) If subdivision (i) of this subparagraph does not apply, the amount of gain to be taken into account for an element under section 1250(a)(2) is the product of:

(*a*) The additional depreciation attributable to periods before January 1, 1970, for the element, multiplied by,

(*b*) The applicable percentage for the element determined under section 1250(a)(2), and multiplied by,

(*c*) A ratio, computed by dividing (*1*) the lower of the additional depreciation in respect of the property as a whole which is attributable to periods before January 1, 1970,

or the remaining gain (or remaining potential gain), by (*2*) the sum of the additional depreciation attributable to periods before January 1, 1970, in respect of each element having additional depreciation.

(6) *Step (5)*. The fifth step is to compute the sum of the amount of gain for each element, as determined in steps (2) and (4).

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

Example 1. Gain of $60,000 is realized upon a sale, after the December 31, 1969, of section 1250 property which was constructed by the taxpayer after such date. The property consists of four elements (W, X, Y, and Z). Since on the date of sale the amount of additional depreciation attributable to periods after December 31, 1969, in respect of the property as a whole ($32,000), is equal to the sum of the additional depreciation in respect of each element having such additional depreciation and is less than the gain realized, the gain recognized for each element is determined under subparagraph (3)(i) of this paragraph. The amount of gain taken into account under section 1250(a)(1) is $28,500, as determined in the following table in accordance with the additional facts assumed:

Element	Additional depreciation after Dec. 31, 1969 ×	Applicable percentage= (1250(a)(1))	Gain for element
W	$14,000 ×	80=	$11,200
X	6,000 ×	90=	5,400
Y	2,000 ×	95=	1,900
Z	10,000 ×	100=	10,000
Total	32,000		28,500

Example 2. Assume the same facts as in example (1), except that the property was acquired by the taxpayer before January 1, 1970. Since the gain realized ($60,000) exceeds the additional depreciation attributable to periods after December 31, 1969 ($32,000), section 1250(a)(2) applies to the remaining gain of $28,000. Since the additional depreciation in respect of the property as a whole attributable to periods before January 1, 1970 ($21,000), is equal to the sum of the additional depreciation in respect of each element having such additional depreciation and is less than the remaining gain ($28,000), the amount of gain recognized for each element under section 1250(a)(2) is determined under subparagraph (5)(i) of this paragraph. The amount of gain taken into account under section 1250(a)(1) is $28,500 the same as in example (1). The amount of gain taken into account under section 1250(a)(2) is $3,900, as determined in the following table in accordance with the additional facts assumed:

Element	Additional depreciation before Jan. 1, 1970 ×	Applicable percentage= (1250(a)(2))	Gain for element (1250)(a)(2))
W	$8,000 ×	0=	$0
X	6,000 ×	10=	600
Y	2,000 ×	15=	300
Z	5,000 ×	60=	3,000
Total	21,000		3,900

Example 3. (i) The facts are the same as in example (2) except that element Y has a deficit in additional depreciation attributable to periods after December 31, 1969, of $6,000 and thus the additional depreciation attributable to periods after December 31, 1969, in respect of the property as a whole is $24,000. The sum of the additional depreciation for each element having additional depreciation is $30,000, or $6,000 more than the additional depreciation in respect of the property as a whole. Thus, the gain recognized for each element under section 1250(a)(1) is determined under subparagraph (3)(ii) of this paragraph. The ratio referred to in subparagraph (3)(ii) (*c*) of this paragraph is 24:30, that is, the lower of the additional depreciation in respect of the property as a whole attributable to periods after December 31, 1969 ($24,000), or the gain realized ($60,000), divided by the sum of the additional depreciation in respect of each element having such additional depreciation ($30,000). The amount of gain taken into account under section 1250(a)(1) is $21,280, as determined in the following table:

Element	Additional depreciation ×	Applicable percentage × (1250(a)(1))	Ratio=	Gain for element
W	$14,000 ×	80 ×	24:30=	$8,960
X	6,000 ×	90 ×	24:30=	4,320
Y	(6,000) ×	95 ×	24:30=	0
Z	10,000 ×	100 ×	24:30=	8,000
Total	24,000			21,280

(ii) In addition, gain is recognized under section 1250(a)(2) since there is a remaining potential gain of $36,000, that is, gain realized ($60,000) minus the additional depreciation attributable to periods after December

31, 1969 ($24,000). The gain recognized in respect of each element and the gain recognized under section 1250(a)(2) ($3,900) are the same as in example (2), since the additional depreciation attributable to periods before January 1, 1970 ($21,000) is less than the remaining gain ($36,000).

(c) *Element*—(1) *General*. For purposes of this section, in the case of section 1250 property there shall be treated as separate elements the separate improvements, units, remaining property, special elements, and low-income housing elements which are respectively referred to in paragraphs (c) (2), (3), (4), (5), and (6) of this section.

(2) *Separate improvements*. There shall be treated as an element each *separate improvement* (as defined in paragraph (d)(1) of this section) to the property.

(3) *Units*. If before completion of section 1250 property one or more units thereof are placed in service, each such unit of the section 1250 property shall be treated as an element.

(4) *Remaining property*. The remaining property which is not taken into account under subparagraph (2) or (3) of this paragraph shall be treated as an element.

(5) *Special elements*. (i) If the basis of section 1250 property is reduced in the manner described in paragraph (b)(2)(ii) of § 1.1250–3 (relating to property acquired from a decedent prior to his death) or in paragraph (e)(3)(iii) of § 1.1250–3 (relating to basis reduction under section 1071 or 1082(a)(2)), then such property shall be considered as having a special element with additional depreciation equal to the amount of additional depreciation included in the depreciation adjustments (referred to in paragraph (d)(1) of § 1.1250–2) to which the basis reduction is attributable. For purposes of computing applicable percentage, the holding period of a special element under this subdivision shall be determined under paragraph (b)(2)(ii) or (e)(3)(iii) (whichever is applicable) of § 1.1250–3.

(ii) If a disposition described in section 1250(d)(4)(A) (relating to like kind exchanges and involuntary conversions) of a portion of an item of property gives rise to an addition to capital account (described in the last sentence of paragraph (d)(2)(i) of this section) which is not a separate improvement, then such property shall be considered as having a special element with additional depreciation and, for purposes of computing applicable percentage, a holding period determined under paragraph (d)(7) of § 1.1250–3.

(6) *Low-income housing elements*. If, in an approved disposition of a qualified housing project, a replacement qualified housing project is treated as consisting of more than one element of section 1250 property by reason of section 1250(d)(8)(E) (see paragraph (h)(2) of § 1.1250–3), the elements determined under such section shall be treated as elements for purposes of this section. For definition of the terms *qualified housing project* and *approved disposition*, see section 1039(b) and the regulations thereunder.

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

Example 1. A taxpayer constructs an apartment house which he places in service in three stages. The total cost is $1 million, of which $350,000 is allocable to the first stage, $500,000 to the second stage, and $150,000 to the third stage. The first stage, which is placed in service on January 1, 1965, consists of 300 apartments and certain facilities including a central heating system and a common lobby. The second stage, which is placed in service on July 15, 1965, consists of 550 apartments and certain facilities including the motor for a central air-conditioning system. The third stage, which is placed in service on January 19, 1966, consists of the residue of the apartment house. On December 31, 1968, the taxpayer disposes of the apartment house. On such date, the apartment house has three elements which are described in the table below:

Stage	Kind of element	Cost	Full months in holding period	Applicable percentage
1	Unit	$350,000	48	72
2	Unit	500,000	42	78
3	Remaining property.	150,000	36	84

Example 2. Assume the same facts as in example (1) except that on January 1, 1969, two new floors, which were added after the apartment house was completed, are placed in service and that on July 1, 1972, the taxpayer disposes of the building. Assume further that the two new floors are one separate improvement (within the meaning of paragraph (d) of this section). On the date disposed of, the property consists of four elements, that is, the three elements described in example (1) and the separate improvement.

(d) *Separate improvement*—(1) *Definition*. For purposes of this section, with respect to any section 1250 property, the term *separate improvement* means an *addition to capital account* described in subparagraph (2) of this paragraph which qualifies as an *improvement* under the 1-year test prescribed in subparagraph (3) of this paragraph and which satisfies the 36-month test prescribed in subparagraph (4) of this paragraph.

(2) *Addition to capital account*. (i) In the case of any section 1250 property, an addition to capital account described in this subparagraph is any addition to capital account in respect of such property after its initial acquisition or completion by the taxpayer or by any person who held the property during a period included in the taxpayer's holding period (see §1.1250–4) for the property. An addition to the capital account of section 1250 property may arise, for example, if there is an expenditure for section 1250 property which is an improvement, replacement, addition, or alteration to such property (regardless of whether the cost thereof is capitalized or charged against the depreciation reserve). In such a case, the *addition to capital account* is the gross addition, unreduced by amounts attributable to replaced property, to the net capital account and not the net addition to such account. Thus, if a roof has an adjusted basis of $20,000, and is replaced by constructing a new roof at a cost of $50,000, the gross addition of $50,000 is an addition to capital account. (The adjusted basis of the old roof is no longer included in the capital account for the property.) For purposes of this section, the status of an addition to capital account is not affected by whether or not it is treated as a separate property for purposes of determining depreciation adjustments. In case of an addition to the capital account of property arising after December 31, 1963, upon a disposition referred to in section 1250(d)(4) (relating to like kind exchanges and involuntary conversions) of a portion of an item of such property, the amount of such addition (and its basis for all purposes of the Code) shall be the basis thereof determined under paragraph (d) (2), (3), or (4) (whichever is applicable) of §1.1250–3, applied by treating such portion and such addition as separate properties.

(ii) An addition to capital account may be attributable to an excess of the adjusted basis of section 1250 property in the hands of a transferee immediately after a transaction referred to in section 1250(e)(2) (relating to holding period of property with transferred basis) over its adjusted basis in the hands of the transferor immediately before the transaction. Thus, for example, such excess may arise from a gift which is in part a sale or exchange (see paragraph (a)(2) of §1.1250–3), from an increase in basis due to gift tax paid (see section 1015(d)), from a transfer referred to in paragraph (c)(2) of §1.1250–3 (relating to certain tax-free transactions) in which gain is partially recognized, or from a distribution by a partnership to a partner in which no gain is recognized by reason of the application of section 731. Similarly, an addition to capital account may be attributable to an excess of the adjusted basis of a principal residence acquired in a transaction referred to in section 1250(e)(3) over the adjusted basis of the principal residence disposed of, as well as to any increase in the adjusted basis of section 1250 property of a partnership by reason of an optional basis adjustment under section 734(b) or 743(b).

(iii) Whether or not an expenditure shall be treated as an addition to capital account described in this subparagraph, as distinguished from a separate item of property, may depend on how the property or properties are disposed of. Thus, for example, if a taxpayer, who owns a motel consisting of 10 buildings with common heating and plumbing systems, adds to the motel three new buildings which are connected to the common systems, and if the taxpayer sells the motel to one person in one transaction, then for purposes of this subparagraph the cost of the three new buildings shall be treated as an addition to the capital account of the motel and, if the 1-year and 36-month tests of subparagraphs (3) and (4) of this paragraph are satisfied, the motel consists of at least two elements. If, however, the 10-building group and the three-building group were individually sold in separate transactions to two different people

each of whom would operate his group as a separate business, the motel would consist of two items of property.

(3) *One-year test for improvement.* (i) An addition to capital account of section 1250 property for any taxable year (including a short taxable year and the entire taxable year in which the disposition occurs) shall be treated as an improvement only if the sum of all additions to the capital account of such property for such taxable year exceeds the greater of:

(*a*) $2,000, or

(*b*) One percent of the unadjusted basis of the property, determined as of the beginning (*1*) of such taxable year, or (*2*) of the holding period (within the meaning of §1.1250–4) of the property, whichever is the later.

(ii) For purposes of this section, the term *unadjusted basis* means the adjusted basis of the property, determined without regard to the adjustments provided in section 1016(a) (2) and (3) (relating to adjustments for depreciation, amortization, and depletion). For purposes of this paragraph, as of any particular date the unadjusted basis of section 1250 property (*a*) includes the cost of any addition to capital account for the property which arises prior to such date (regardless of whether such addition qualified under this subparagraph as an improvement), and (*b*) does not include the cost of a component retired before such date.

(iii) In respect of a particular disposition of section 1250 property by a person:

(*a*) There shall not be taken into account under the 1-year test for improvements in this subparagraph any addition to capital account which arises by reason of (or after) such disposition or which arises before the beginning of the holding period under §1.1250–4 of such person for the property, and

(*b*) Such test shall be made in respect of each taxable year of such person (and of any prior transferor) any day of which is included under §1.1250–4 in such person's holding period for the property, except that (*1*) such test shall be made for a taxable year of such person only if such person actually owned the property on at least 1 day of such taxable year, and (*2*) such test shall be made for a taxable year of such prior transferor only if such prior transferor actually owned the property on at least 1 day of such taxable year.

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

Example 1. The unadjusted basis of section 1250 property as of the beginning of January 1, 1960, is $300,000. During the taxable year ending on December 31, 1960, the only additions to the capital account for the property are addition A on January 1, 1960, costing $1,000, and addition B on July 1, 1960, costing $600. Since the sum of the amounts added to capital account for such taxable year is less than $2,000, A and B are not treated as improvements. This result would not be changed if addition C, costing $600, were added on December 15, 1960, since although the sum of the additions ($1,000 plus $600 plus $600, or $2,200) exceeds $2,000, such sum is less than 1 percent of the unadjusted basis of the property as of the beginning of 1960 ($3,000, that is, 1 percent of $300,000). If however, C cost $1,500, then A, B, and C would each be considered an improvement since the sum of the amounts added to capital account $3,100) would exceed $3,000.

Example 2. Green and his son both use the calendar year as the taxable year. On February 1, 1965, Green makes addition A to a piece of section 1250 property. On June 15, 1965, Green transfers such property to his son as a gift which is in part a sale (see paragraph (a) of §1.1250–3). Addition B arises by reason of the transfer. On August 1, 1965, the son makes addition C to the property. For purposes of determining the amount of gain recognized under section 1250(a) to Green upon the transfer, the determination of whether addition A is an improvement is made without taking into account additions B and C. For purposes of determining the amount of gain recognized under section 1250(a) upon a subsequent disposition of the property by the son, additions B and C would be taken into account in the determination of whether A is an improvement, and A would be taken into account in the determination of whether B and C are improvements.

Example 3. Assume the same facts as in example (2). Assume further that on September 15, 1965, the son transfers the property to a corporation in exchange for cash and stock in the corporation in a transaction qualifying under section 351 (see paragraph (c) of §1.1250–3), and that the corporation uses a fiscal year ending November 30. For purposes of determining the amount of gain recognized under section 1250(a) upon a subsequent disposition by the corporation, the one-year

test under subdivision (i) of this subparagraph is made for the entire taxable year of Green and of the son ending on December 31, 1965, and in respect of the corporation's taxable year ending November 30, 1965. Accordingly, if on December 7, 1965, addition D is made by the corporation, then, upon a subsequent disposition by the corporation, D is taken into account for purposes of the determination in respect of the entire taxable year of Green and of the son ending on December 31, 1965, and for the corporation's taxable year ending November 30, 1966, but not for purposes of the corporation's taxable year ending November 30, 1965. If D were made on January 3, 1966, D would still be taken into account for purposes of the determination in respect of the corporation's taxable year ending November 30, 1966. However, since neither Green nor his son actually owned the property on any day of the taxable year ending December 31, 1966, no determination is made in respect of such taxable year of Green or of the son.

(4) *36-month test for separate improvement.* (i) If, during the 36-month period ending on the last day of any taxable year (including a short taxable year and the entire taxable year in which the disposition occurs), the sum of the amounts treated under subparagraph (3) of this paragraph as improvements for such period exceeds the greatest of:

(*a*) 25 percent of the adjusted basis of the property,

(*b*) 10 percent of the unadjusted basis (determined under subparagraph (3)(ii) of this paragraph) of the property, or

(*c*) $5,000,

Then each such improvement during such period shall be treated as a separate improvement, and thus as an element. For purposes of (*a*) and (*b*) of this subdivision, the adjusted basis (or unadjusted basis) of section 1250 property shall be determined as of the beginning of the 36-month period, or as of the beginning of the holding period of the property (within the meaning of § 1.1250–4), whichever is the later.

(ii) In respect of a particular disposition of section 1250 property by a person:

(*a*) There shall not be taken into account under the 36-month test for separate improvements in this subparagraph any amount treated under subparagraph (3) of this paragraph as an improvement which arises by reason of (or after) the disposition or which arises before the beginning of the holding period under § 1.1250–4 of such person for the property, and

(*b*) Such test shall be made in respect of each 36-month period ending on the last day of each taxable year of such person (and of any prior transferor) if at least 1 day of such period is included under § 1.1250–4 in such person's holding period for the property, except that (*1*) such test shall be made for a 36-month period ending on the last day of a taxable year of such person only if such person actually owned the property on at least 1 day of such period, and (*2*) such test shall be made for a 36-month period ending on the last day of a taxable year of such prior transferor only if such prior transferor actually owned the property on at least 1 day of such period.

(iii) For illustration of the principles of subdivision (ii) of this subparagraph, see examples (2) and (3) in subparagraph (3)(iv) of this paragraph.

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

Example: (i) On December 31, 1967, X, a calendar year taxpayer, purchases an item of section 1250 property at a cost of $100,000. In the table below, the adjusted basis and unadjusted basis of the property are shown for the beginning of January 1 of each taxable year and it is assumed that each addition to capital was added on January 1 of the year shown.

Year	Adjusted basis	Unadjusted basis	1 percent of unadjusted basis	Addition
1969	$94,000	$100,000	$1,000	A–$10,000
1970	97,030	110,000	1,100	B–4,000
1971	94,041	114,000	1,140	C–6,000
1972	92,799	120,000	1,200	.....
1973	86,158	120,000	1,200	D–18,000

(ii) Since each addition to capital account for the property exceeds the greater of $2,000 or one percent of unadjusted basis, determined as of the beginning of the taxable year in which made, each addition to capital account qualifies as an improvement under subparagraph (2) of this paragraph.

(iii) Since the beginning of the holding period of the property under § 1.1250–4 (Jan. 1, 1968) is later than the beginning of the 36-month period ending on December 31, 1969, the determination as to whether there are any separate improvements on the property as of December 31, 1969, is made by examining the adjusted basis (or unadjusted basis) of the property as of the beginning of January 1, 1968. As of December 31, 1969, there

were no separate improvements on the property since the only amount treated as an improvement for the period beginning on January 1, 1968, and ending on December 31, 1969, in addition A (costing $10,000), which is less than $25,000, that is, 25 percent of the adjusted basis ($100,000) of the property as of the beginning of January 1, 1968.

(iv) As of December 31, 1970, there were no separate improvements on the property since the sum of the amounts treated as improvements for the 36-month period ending on December 31, 1970, is $14,000 (that is, $10,000 for A, plus $4,000 for B), and this sum is less than $25,000, that is, 25 percent of the adjusted basis ($100,000) of the property as of the beginning of January 1, 1968.

(v) As of December 31, 1971, there were no separate improvements on the property since the sum of the amounts treated as improvements for the 36-month period ending on December 31, 1971, is $20,000 (that is, $10,000 for A, plus $4,000 for B, plus $6,000 for C), and this sum is less than $23,500, that is, 25 percent of the adjusted basis ($94,000) of the property as of the beginning of January 1, 1969.

(vi) As of December 31, 1972, there were no separate improvements on the property since the sum of the amounts treated as improvements for the 36-month period ending on December 31, 1972, is $10,000 (that is, $4,000 for B plus $6,000 for C), and this sum is less than $24,258 that is, 25 percent of the adjusted basis ($97,030) of the property as of the beginning of January 1, 1970.

(vii) As of December 31, 1973, C and D are separate improvements (notwithstanding that as of December 31, 1971 and 1972, C was not a separate improvement) since the sum of the amounts added for the 36-month period ending December 31, 1973, is $24,000 (that is, $6,000 for C plus $18,000 for D), and this sum exceeds the greatest of:

(*a*) $23,510, that is, 25 percent of the adjusted basis ($94,041) of the section 1250 property as of the beginning of January 1, 1971,

(*b*) $11,400, that is, 10 percent of the unadjusted basis ($114,000) of the property as of the beginning of such first day, or

(*c*) $5,000.

(e) *Additional depreciation and holding period of property acquired in certain transactions*—(1) *Transferred basis.* If property consisting of two or more elements is disposed of, and if the holding period of the property in the hands of the transferee for purposes of computing applicable percentage includes the holding period of the transferor by reason of the application of paragraph (c) (other than subparagraph (2) thereof) of § 1.1250–4, then the additional depreciation for each element of the property in the hands of the transferee immediately after the transfer shall be computed in the manner set forth in this subparagraph. First, any element having a deficit in additional depreciation in the hands of the transferor immediately before such transfer shall be considered to have the same deficit in the hands of the transferee. Second, elements having additional depreciation in the hands of the transferor immediately before the transfer shall be considered to have additional depreciation in the hands of the transferee. The sum of the transferee's additional depreciation for all elements of the property having additional depreciation in the hands of the transferor shall be an amount equal to the additional depreciation in respect of the property as a whole immediately after the transfer increased by the sum of the deficits in addition depreciation for all elements having such deficits. In case there is more than one element having additional depreciation, the additional depreciation for any such element in the hands of the transferee shall be computed by multiplying (i) the amount computed under the preceding sentence by (ii) the additional depreciation for such element in the hands of the transferor divided by the sum of the additional depreciation for all such elements having additional depreciation in the hands of the transferor. For purposes of computing applicable percentage, the holding period for an element of such property in the hands of the transferee shall include the holding period of such element in the hands of the transferor.

(2) *Example.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example: Section 1250 property has additional depreciation of $16,000 of which $12,000 is additional depreciation for element X and $4,000 for element Y. The property is transferred to a corporation in exchange for cash of $6,000 and for stock in the corporation. Assume that recognition of gain under section 1250(a) is limited to $6,000 (the amount of cash received) by reason of the application of section 351(b) (relating to transfer to corporation controlled by transferor) and section 1250(d)(3) (relating to limitation on application of section 1250 in certain tax-free transactions). Under paragraph (c)(3)(i) of § 1.1250–3, the additional depreciation for the property in the hands of the corporation immediately after the transfer is $10,000, that

is, the additional depreciation for the property in the hands of the transferor immediately before the transfer ($16,000) minus the gain under section 1250(a) recognized upon the transfer ($6,000). Under subparagraph (1) of this paragraph, in the hands of the corporation immediately after the transfer element X has additional depreciation of $7,500 (12/16 of $10,000) and element Y as additional depreciation of $2,500 (4/16 of $10,000). Under paragraph (d)(2)(ii) of this section there is an addition of $6,000 to the capital account for the property.

(3) *Principal residence.* If a principal residence consisting of two or more elements is disposed of, and if for purposes of computing applicable percentage the holding period of the principal residence acquired includes the holding period of the principal residence disposed of by reason of the application of paragraph (d) of § 1.1250–4, then the additional depreciation (or a deficit in additional depreciation) for an element of the principal residence acquired immediately after the transaction shall be determined in a manner consistent with the principles of subparagraph (1) of this paragraph. For purposes of computing applicable percentage, the holding period for an element of the principal residence acquired includes the holding period of such element of the principal residence disposed of, but not the period beginning on the day after the date of the disposition and ending on the date of the acquisition.

(f) *Holding period for small separate improvements*—(1) *General.* This paragraph prescribes a special holding period solely for the purpose of computing the applicable percentage of a separate improvement (as defined in paragraph (d) of this section) which is treated as an element. See paragraph (a)(2)(ii) of this section for determination of holding period under section 1223 for purposes of computing additional depreciation. In respect of section 1250 property, if the amount of a separate improvement does not exceed the greater of:

(i) $2,000, or

(ii) One percent of the unadjusted basis (within the meaning of paragraph (d)(3)(ii) of this section) of such property, determined as of the beginning of the taxable year in which such separate improvement was made,

Then such separate improvement shall be treated for purposes of computing applicable percentage as placed in service on the first day, of a calendar month, which is the closest such first day to the middle of the taxable year. See the last sentence of section 1250(f)(4)(B). If two such first days are equally close to the middle of the taxable year, the earliest of such days is the applicable day.

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

Example: (i) The unadjusted basis of section 1250 property as of the beginning of January 1, 1960, is $100,000. During the taxable year ending on December 31, 1960, the only additions to the capital account for the property are addition A on March 10, 1960, costing $1,200 and addition B on September 16, 1960, costing $1,400. Since the sum of the additions ($2,600) exceeds the greater of $2,000 and 1 percent of unadjusted basis ($1,000, that is, 1 percent of $100,000), each addition is an improvement under the 1-year test of paragraph (d)(3) of this section. Assume that the 36-month test of paragraph (d)(4) of this section is satisfied and, therefore, each addition is a separate improvement treated as an element.

(ii) Since each element is less than $2,000, the provisions of this paragraph apply. Since there are 366 days in 1960, the middle of the year is at the end of 183 days, or July 1. Thus, that first day of a calendar month in 1960, which is the closest first day (of a calendar month) to the middle of the taxable year, is July 1, 1960. Accordingly, for purposes of computing applicable percentage, elements A and B are each treated as placed in service on July 1, 1960.

[T.D. 7084, 36 FR 275, Jan. 8, 1971, as amended by T.D. 7193, 37 FR 12957, June 30, 1972; T.D. 7400, 41 FR 5103, Feb. 4, 1976]

§ 1.1251–1 General rule for treatment of gain from disposition of property used in farming where farm losses offset nonfarm income.

(a) *Applicability.* The provisions of section 1251, this section, and §§ 1.1251–2 through 1.1251–4 shall apply with respect to any taxable year beginning after December 31, 1969, but only if (1) there is a farm net loss (as defined in section 1251(e)(2) and paragraph (b) of § 1.1251–3) for the taxable year, or (2) there is a balance in the excess deductions account (as described in § 1251–2) as of the close of the taxable year before subtracting any amount under paragraph (c)(1)(i) of § 1251–2. See section 1251(a). In general, a taxpayer who

has a farm net loss and certain other taxpayers are required to establish and maintain an excess deductions account as provided in section 1251(b). Certain additions and subtractions are made to the excess deductions account, and upon the disposition of *farm recapture property* any gain to the extent of the balance in the excess deductions account is recognized as ordinary income under section 1251(c)(1). See paragraph (b)(1) of this section. *Farm recapture property* is, in general, certain farming property (other than section 1250 property) described in paragraph (1), (3), or (4) of section 1231(b). See paragraph (a) of § 1.1251–3.

(b) *Ordinary income*—(1) *General rule*. In general, subject to the provisions of subparagraphs (2), (3), (4), and (5) of this paragraph, upon a disposition of an item of farm recapture property during a taxable year beginning after December 31, 1969, the amount of which:

(i) In the case of a sale, exchange, or involuntary conversion, the amount realized, or

(ii) In the case of any other disposition, the fair market value of such property

exceeds the adjusted basis of such property shall be recognized under section 1251(c)(1) as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income). The amount of gain recognized as ordinary income under section 1251(c)(1) shall be determined separately for each item of farm recapture property in a manner consistent with the principles of subparagraphs (4) and (5) of § 1.1245–1(a) (relating to gain from dispositions of certain depreciable property). Generally, such ordinary income treatment applies even though in the absence of section 1251(c)(1) no gain would be recognized under the Code. For example, if a corporation distributes farm recapture property as a dividend gain may be recognized as ordinary income to the corporation even though, in the absence of section 1251(c)(1), section 311(a) would preclude any recognition of gain to the corporation. For purposes of section 1251, the term *disposition* shall have the same meaning as in paragraph (a)(3) of § 1.1245–1. For the relation of section 1251 to other provisions of the Code, see paragraph (e) of this section.

(2) *Limitation as to dispositions of land*—(i) *In general*. In the case of a disposition of land, gain shall be recognized as ordinary income under section 1251(c)(1) only to the extent of the land's *potential gain*. See section 1251(c)(2)(C).

(ii) *Potential gain*. For purposes of section 1251, the term *potential gain* means in respect of land an amount equal to the excess of its fair market value over its adjusted basis, but limited to the extent of the deductions allowable in respect to such land pursuant to an election (if any) under sections 175 (relating to soil and water conservation expenditures) and 182 (relating to expenditures by farmers for clearing land) for the taxable year of disposition and the four immediately preceding taxable years regardless of whether any such preceding taxable year begins before December 31, 1969. See section (e)(5).

(iii) *Cross reference*. For additional recapture of certain deductions allowed under sections 175 and 182 in respect of farm land, see section 1252.

(3) *Exceptions and special rules*. The amount of gain to be recognized as ordinary income under section 1251(c)(1) after applying subparagraph (2) of this paragraph, if applicable, shall be subject to the exceptions and special rules of section 1251(d) and § 1.1251–4.

(4) *Limitation as to amount in excess deductions account*—(i) *In general*. The aggregate of the amount of gain recognized as ordinary income under section 1251(c)(1) (after applying subparagraphs (2) and (3) of this paragraph, if applicable) shall not exceed the amount in the excess deductions account at the close of the taxable year after subtracting from the account the amount specified in section 1251(b)(3)(A) and paragraph (c)(1)(i) of § 1.1251–2. See section 1251(c)(2)(A). For transfer of amount in an excess deductions account, see section 1251(b)(5).

(ii) *Dispositions taken into account*. If the aggregate of the amount to which section 1251(c)(1) applies is limited for any taxable year by the application of subdivision (i) of this subparagraph, section 1251(c)(1) shall apply in respect

of dispositions of items of farm recapture property in the order made. See section 1251(c)(2)(B).

(5) *Relationship to section 1245.* If property is disposed of which qualifies as both section 1245 property (as defined in section 1245(a)(3)) as well as farm recapture property, then gain shall be recognized as ordinary income under section 1251(c)(1) only to the extent that the amount of any gain realized (in the case of a sale, exchange, or involuntary conversion), or to the extent that the excess of the fair market value of the property over its adjusted basis (in the case of any other disposition), was not recognized as ordinary income under section 1245(a)(1). The amount of gain recognized as ordinary income under section 1245(a)(1) upon a disposition of farm recapture property (i) is taken into account under paragraph (b)(2) of § 1.1251–3 for purposes of computing farm net loss (or farm net income) and (ii) is not under paragraph (c)(1)(ii) of § 1.1251–2 subtracted from the excess deductions account.

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

Example 1. A, an unmarried individual who uses the calendar year as his taxable year, makes one disposition of farm recapture property during 1970. On June 30, 1970, he sells for $75,000 farm recapture property (other than land) with an adjusted basis of $43,000 for a realized gain of $32,000 none of which is recognized under section 1245. The balance in A's excess deductions account is $39,000 at the close of 1970 (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A)). Hence, the entire gain of $32,000 is recognized as ordinary income under section 1251(c)(1), and the balance remaining in A's excess deductions account is $7,000. If, however, the original balance in the excess deductions account were only $15,000, then only $15,000 would be recognized as ordinary income under section 1251(c)(1) and A's excess deductions account balance would be reduced to zero. The remaining gain of $17,000 may be treated as gain from the sale or exchange of property described in section 1231.

Example 2. M, a calendar year corporation makes one disposition of farm recapture property during 1975. On January 15, 1975, M distributes as a dividend to its shareholders land which it had acquired on March 3, 1970. On that date, the excess of the fair market value ($67,500) over the adjusted basis of land ($45,000) is $22,500 and the sum of the deductions allowable in respect of such land under sections 175 and 182 is $5,000 for 1970 and $13,000 for the taxable year of disposition and the four immediately preceding taxable years. Thus, the potential gain (as defined in subparagraph (2)(ii) of this paragraph) is limited to $13,000. At the end of M's taxable year (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A) there is a balance of $25,000 in the excess deductions account of M. Since such balance exceeds the potential gain, M recognizes $13,000 as ordinary income under section 1251(c)(1) even though, in the absence of that provision, section 311(a) would preclude recognition of gain to M. The balance in M's excess deductions account is reduced by $13,000, from $25,000 to $12,000. With respect to the treatment of the remaining gain ($9,500) from the disposition of the land, see section 1252 and example (2) of paragraph (e) § 1.1252–1.

Example 3. Assume the same facts as in example (2), except that M makes a second disposition of farm recapture property during 1975. On June 5, 1975. M sells for $55,000 a breeding herd of cattle having an adjusted basis of $35,000 for a realized gain of $20,000. M had acquired the herd on April 1, 1971. Assume further that $6,000 of the $20,000 gain realized is treated as ordinary income under section 1245(a)(1). Thus, the amount of gain M would recognize as ordinary income under section 1251(c)(1), computed before applying the excess deductions account limitation, is $14,000. In accordance with the computation in example (1) of paragraph (c)(2) of § 1.1251–2, the excess deductions account limitations limit the maximum amount of gain which can be recognized as ordinary income under section 1251(c)(1) upon the disposition of the land and the breeding herd to $25,000. Under subparagraph (4)(ii) of this paragraph, the amount of such limitation, $25,000, is assigned to each property in the order of disposition. Thus, the amount of gain recognized as ordinary income under section 1251 is $13,000 (as in example (1) of this subparagraph) on the disposition of the land and $12,000 on the disposition of the breeding herd. The remaining gain of $2,000 (i.e., $14,000 minus $12,000) on the disposition of the breeding herd may be treated as gain from the sale or exchange of property described in section 1231.

(c) *Instances of nonapplication*—(1) *In general.* Section 1251 does not apply with respect to dispositions of farm recapture property by a taxpayer during a taxable year if at the close of such year after making the necessary additions and subtractions under section 1251(b) (2) and (3)(A), there is no balance in the taxpayer's excess deductions account.

(2) *Losses*. Section 1251(c)(1) does not apply to losses. Thus, section 1251(c)(1) does not apply if a loss is realized upon a sale, exchange or involuntary conversion of property, all of which is farm recapture property, nor does the section apply to a disposition of such property other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of such property is not greater than its adjusted basis.

(3) *Certain dispositions of interests in land*. Section 1251(c)(1) does not apply to dispositions of interests in land with respect to which no deductions were allowable pursuant to an election under section 175 (relating to soil and water conservation expenditures) and 182 (relating to expenditures by farmers for clearing land) for the taxable year of disposition and the four immediately preceding taxable years. For possible application of section 1252 in such a case, see example (1) of paragraph (e) of § 1.1252–1.

(d) *Partnerships*. [Reserved]

(e) *Relation of section 1251 to other provisions*—(1) *General*. The provisions of section 1251 apply (after applying paragraph (b)(5) of this section, relating to section 1245 property) notwithstanding any other provision of subtitle A of the Code. Thus, unless an exception or special rule under section 1251(d) and § 1.1251–4 applies, gain under section 1251(c)(1) is recognized notwithstanding any contrary nonrecognition provision or income characterizing provision. For example, section 1251 overrides section 1231 (relating to property used in a trade or business). Accordingly, gain recognized under section 1251(c)(1) upon a disposition of farm recapture property will be treated as ordinary income to the extent of the balance in the taxpayer's excess deductions account, and only the remaining gain, if any, from the disposition may be considered as gain from the sale or exchange of a capital asset if section 1231 is applicable. See example (3) of paragraph (d)(6) of this section.

(2) *Nonrecognition sections overridden*. The nonrecognition of gain provisions of subtitle A of the Code which section 1251 overrides include, but are not limited to, sections 267(d), 311(a), 336, 337, and 512(b)(5). See section 1251(d) and § 1.1251–4 for the extent to which 1251(c)(1) overrides sections 332, 351, 361, 371(a), 374(a), 721, 1031, and 1033.

(3) *Treatment of gain not recognized under section 1251(c)(1)*. For treatment of gain not recognized under section 1251(c)(1), the principles of paragraph (f) § 1.1251–6 shall be applicable. Thus section 1251 does not prevent gain which is not recognized under section 1251 from being considered as gain under another provision of the Code, such as for example, section 1252(a)(1) (relating to treatment of gain from disposition of farm land). See example (1) of paragraph (e) of § 1.1252–1.

(4) *Exempt income*. With regard to exempt income, the principles of paragraph (e) of § 1.1245–6 shall be applicable.

(5) *Normal retirement of asset in multiple asset account*. Section 1251(c)(1) does not require recognition of gain upon normal retirements of farm recapture property in a multiple asset account as long as the taxpayer's method of accounting, as described in paragraph (e)(2) of § 1.167(a)–8 (relating to accounting treatment of asset retirements), does not require recognition of such gain.

(6) *Installment method*—(i) *In general*. Gain from a disposition to which section 1251(c)(1) applies may be reported under the installment method if such method is otherwise available under section 453 of the Code. In such case, the income (other than interest) on each installment payment shall be deemed to consist of gain to which section 1251(c)(1) applies until all such gain has been reported, and the remaining portion (if any) of such income shall be deemed to consist of gain to which section 1251(c)(1) does not apply. For treatment of amounts as interest on certain deferred payments, see section 483. For adjustments in the excess deductions account, see paragraph (c)(1)(ii) of § 1.1251–2.

(ii) *Special rule*. If a taxpayer disposes of property used in the trade or business of farming which qualifies as both section 1245 property as well as farm recapture property and elects to report the gain from such disposition under the installment method, then the income (other than interest) on each installment payment shall (*a*) first be

deemed to consist of gain to which section 1245(a)(1) applies until all such gain has been reported, (*b*) The remaining portion (if any) of such income shall be deemed to consist of gain to which section 1251(e)(1) applies until all such gain has been reported, and (*c*) finally the remaining portion (if any) of such income shall be deemed to consist of gain to which neither section 1245(a)(1) nor 1251 (c)(1) applies. See paragraph (d)(3) of §1.1252–1 with respect to the installment method in regard to the disposition of property which is both farm recapture property as well as farm land (as defined in section 1252(a)(2) and paragraph (a)(3)(i) of §1.1252–1).

[T.D. 7418, 41 FR 18814, May 7, 1976; 41 FR 23669, June 11, 1976]

§ 1.1251–2 Excess deductions account.

(a) *Establishment and maintenance of account*—(1) *General rule.* With respect to any taxable year beginning after December 31, 1969, any taxpayer who:

(i) Has a farm net loss (as defined in section 1251(e)(2) and in paragraph (b) of §1.1251–3) for such a taxable year, or

(ii) Has an excess deductions account balance as of the close of such a taxable year

shall establish (if not previously established) and maintain for purposes of section 1251 an excess deductions account. See section 1251(b)(1). Once an excess deductions account is established (or succeeded to under paragraph (e) of this section in the case of certain corporate transactions and gifts) all entries (including the entries prescribed by paragraph (f) of this section with respect to married taxpayers who file joint returns) with respect to the account must be part of the taxpayer's permanent records for all taxable years for which the account must be maintained. For purposes of applying section 1251 and this section, the term *taxpayer* in the case of a partnership means each partner of such partnership and in the case of an estate or trust means the estate or trust regardless of whether it is taxable under subpart A or E, subchapter J, chapter 1 of the Code.

(2) *Distributions from estate or trust.* If farm recapture property is distributed from an estate or trust in a transaction to which section 1251(d) (1) or (2) (relating to exceptions for gifts and transfers at death) applies, then the excess deductions account balance of the estate or trust shall be succeeded to by the distributee in the amount, if any, and manner prescribed in paragraph (e)(2) of this section. For purposes of the preceding sentence only, the rules of paragraph (e)(2) of this section shall be applied by treating each distribution as a gift at the time made. Thus; for example, if all of the farm recapture property of an estate or trust is distributed to a distributee on the date the estate or trust terminates, the distributee will succeed on that date to the excess deductions account balance of the estate or trust.

(3) *Exception.* A taxpayer is not required to maintain an excess deductions account under subparagraph (1) of this paragraph for a taxable year if:

(i) For such taxable year there would be no additions to the taxpayer's excess deductions account, and

(ii) For the immediately preceding taxable year the balance in the taxpayer's excess deductions account was reduced to zero by reason of section 1251 (b)(3) (relating to subtractions from the account) or section 1251(b)(5) (relating to transfer of account).

(b) *Additions to account*—(1) *General rule.* For each taxable year, there shall be added to the excess deductions account an amount equal to the taxpayer's farm net loss. See section 1251(b)(2)(A).

(2) *Exceptions.* In the case of an individual and, in the case of an electing small business corporation (as defined in section 1371(b)), subparagraph (1) of this paragraph shall apply for a taxable year:

(i) Only if the taxpayer's nonfarm adjusted gross income (as defined in paragraph (d) of §1.1251–3) for such year exceeds $50,000, and

(ii) Only to the extent the taxpayer's farm net loss for such year exceeds $25,000.

The limitations of this subparagraph apply to a person (other than a trust) to whom the tax rates set forth in section 1 are applicable and as prescribed in subparagraph (3) of this paragraph in respect of an electing small business corporation.

(3) *Electing small business corporation*—(i) *Taxable years ending before December 11, 1971.* For taxable years ending before December 11, 1971, in the case of an electing small business corporation (as defined in section 1371(b):

(*a*) For purposes of subparagraph (2) of this paragraph, the term *the taxpayer* means such corporation or any one of its shareholders, and the term *such year*, in the case of a shareholder, means his taxable year with which or within which the taxable year of the corporation ends (see paragraph (d)(2) of § 1.1251–3 for special rules relating to the computation of nonfarm adjusted gross income of a shareholder of an electing small business corporation), and

(*b*) The limitations in subparagraph (2) of this paragraph shall not apply to the corporation for a taxable year if on any day of such year there is a taxpayer who is a shareholder having, for his taxable year with which or within which the taxable year of such corporation ends, a farm net loss (as defined in paragraph (b) of § 1.1251–3).

For purposes of determining whether a shareholder of such corporation has a farm net loss, there shall not be taken into account his pro rata share of farm net income or loss of any other electing small business corporation for such corporation's taxable year ending with or within his taxable year.

(*c*) The provisions of this subdivision (i) do not apply for purposes of determining whether the shareholder must make an addition to his excess deductions account and the amount of such addition.

(ii) *Taxable years ending after December 10, 1971.* [Reserved]

(4) *Married individuals*—(i) *Lower limitations for separate returns.* If married taxpayers file separate returns, then for purposes of this paragraph each spouse shall be treated as a separate individual. However, in such case, (*a*) the amount specified in subparagraph (2)(i) of this paragraph shall be $25,000 in lieu of $50,000, and (*b*) the amount specified in subparagraph (2)(ii) of this paragraph shall be $12,500 in lieu of $25,000. The lower limitations in the preceding sentence shall not apply if the spouse of the taxpayer does not have any nonfarm adjusted gross income for the taxable year. See section 1251(b)(2)(C).

(ii) *Joint return.* If married taxpayers for a taxable year file a joint return under section 6013, then for purposes of this paragraph they shall for such taxable year be treated as a single taxpayer. For rules applicable to establishing, maintaining, and allocating a joint excess deductions account, see paragraph (f) of this section.

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

Example 1. For 1971, the M Corporation which uses the claendar year as its taxable year and which is not an electing small business corporation has a farm net loss of $40,000 and nonfarm taxable income of $45,000. Since subparagraph (2) of this paragraph does not apply to M, it is required to make a $40,000 addition to its excess deductions account.

Example 2. For 1971, A, an unmarried individual who uses the calendar year as his taxable year, has a farm net loss of $33,000 and nonfarm adjusted gross income of $65,000. Under subparagraph (2) of this paragraph, A is required to make an addition of $8,000 to his excess deductions account (that is, the excess of the farm net loss, $33,000, over the $25,000 amount referred to in subparagraph (2)(ii) of this paragraph). If, however, A were a trust, the limitation in subparagraph (2) of this paragraph would not apply and such trust would be required to add $33,000 (the amount of the entire farm net loss) to its excess deductions account.

Example 3. H and W each use the calendar year as the taxable year. For 1971, H, a married taxpayer who files a separate return, has a farm net loss of $45,000 and nonfarm adjusted gross income of $60,000. H's spouse W does not have any nonfarm adjusted gross income for 1971. Thus, the lower limitations in subparagraph (4)(i) of this paragraph do not apply. Accordingly, H is required to make an addition of $20,000 to his excess deductions account (that is, the excess of the farm net loss, $45,000, over the $25,000 amount referred to in subparagraph (2)(ii) of this paragraph).

Example 4. Assume the same facts as in example (3), except that for 1971 W has a farm net loss of $10,000 and nonfarm adjusted gross income of $30,000. Thus, the lower limitations in subparagraph (4)(i) of this paragraph do apply and H is required to make an addition of $32,500 to his excess deductions account (that is, the excess of his farm net loss, $45,000, over the $12,500 amount referred to in subparagraph (4)(i)(*b*) of this paragraph). Since, however, W did not have a farm net loss in excess of $12,500, she would not be required to make an addition to her

excess deductions account. For the result if H and W were to file a joint return, see example (1) of paragraph (f)(6) of this section.

Example 5. For 1970, the M Corporation, which uses the calendar year as its taxable year and which is an electing small business corporation, has a farm net loss of $35,000 and nonfarm adjusted gross income of $60,000. A, B, and C, the sole equal shareholders of M, are cash method taxpayers and each uses a fiscal year ending on March 31. For the taxable year ending March 31, 1971, A has a farm net loss of $5,000. Thus, as M's taxable year ends within the taxable year of A during which A has a farm net loss, the limitations in subparagraph (2) of this paragraph do not apply with respect to M for 1970. See subparagraph (1) of this paragraph, to add $35,000 to its excess deductions account.

Example 6. Assume the same facts as in example (5), except that A's farm net loss occurred in his fiscal year ending March 31, 1970, and no shareholder of M has a farm net loss for the fiscal year ending March 31, 1971. Thus, the limitations in subparagraph (2) of this paragraph do apply with respect to M for 1970, and accordingly M is required to add $10,000 to its excess deductions account for 1970 (that is, the excess of M's farm net loss $35,000, over the $25,000 amount referred to in subparagraph (2)(ii) of this paragraph).

Example 7. Assume the same facts as in example (6), except that M has $45,000 of nonfarm adjusted gross income for 1970 and A, for his taxable year ending March 31, 1971, has $40,000 of nonfarm adjusted gross income, computed without regard to his interest in M. Assume the M paid no dividends. Since, under paragraph (d)(2) of §1.1251–3, A's income from M under section 1373(b) is computed on the basis of M's nonfarm adjusted gross income, A's gross income from M is $15,000 (⅓ of $45,000), and A's total nonfarm adjusted gross income is $55,000. Accordingly, M would be required to add $10,000 to its excess deductions account for 1970 for the reasons stated in example (6).

Example 8. Assume the same facts as in example (7). Assume further that A is one of two equal shareholders in N, another electing small business corporation with a taxable year ending on January 31, and that N for its taxable year ending on January 31, 1971, has a $42,000 nonfarm loss and farm net income of $23,000. Assume that N paid no dividends. Thus, A for purposes of subparagraph (2)(i) of this paragraph, would only have a total of $34,000 of nonfarm adjusted gross income ($55,000) computed per example (7) minus $21,000 (A's share of N's nonfarm net operating loss (½ of $42,000) computed in accordance with paragraph (d)(2) of §1.1251–3)). Assuming that no other shareholder of M has nonfarm adjusted gross income in excess of $50,000, by reason of the $50,000 limitation in subparagraph (2)(i) of this paragraph, M makes no addition for 1971 to its excess deductions account. (N would make no addition to its excess deductions account as it does not have a farm net loss.) If, however, N were to have a nonfarm loss of only $8,000, A for purposes of subparagraph (2)(i) of this paragraph would have a total of $51,000 of nonfarm adjusted gross income ($51,000 of nonfarm adjusted gross income ($55,000, minus ½ of N's nonfarm loss of $8,000)). Hence, with respect to M the result would be the same as in example (7) (and N would make no addition to its excess deductions account since it does not have a farm net loss).

Example 9. D and E are equal individual shareholders in corporations X, Y, and Z, the stock of each corporation having recently been purchased from a different unrelated person. X, Y, and Z are electing small business corporations. D, E, and the corporations all use the calendar year as the taxable year. For 1970, the farm net income of D and E (determined without regard to their respective pro rata shares of the farm net income or loss of X, Y, and Z) are $100,000 and zero, respectively. For 1970, the farm net income or loss of the corporations are losses of $80,000 and $20,000 for X and Z, respectively, and income of $60,000 for Y. For 1970, the determinations under subparagraph (3)(ii) of this paragraph as to whether a shareholder of corporation X or Z (no determination is necessary with respect to Y since Y does not have a farm net loss) has a farm net loss are made as follows:

DETERMINATIONS AS TO WHETHER D OR E HAS A FARM NET LOSS

	As to X		As to Z	
	D	E	D	E
Farm net income (determined without regard to X, Y, and Z)	$100,000	$0	$100,000	$0
Pro rata (½) share of corporation's farm net income (or loss):				
Of X			(40,000)	(40,000)
Of Y	30,000	30,000	30,000	30,000
Of Z	(10,000)	(10,000)		
Farm net income (or loss) for purposes of determination	$120,000	$20,000	$90,000	($10,000)

Accordingly, since the determination as to X indicates that neither D nor E has a farm net loss, the limitations of subparagraph (2) of this paragraph apply to X. Thus, assuming that X, D, or E has nonfarm adjusted gross income in excess of $50,000, X will add $55,000 to its excess deductions account, i.e., the excess of the farm net loss, $80,000, over the $25,000 amount referred to in subparagraph (2)(ii) of this paragraph. Since, however, the determination as to Z indicates that E has a farm net loss, such limitations do not apply to Z. Thus, the addition for 1970 to Z's excess deductions account is the entire amount of its farm net loss, $20,000.

(c) *Subtractions from account*—(1) *General rule*. Under section 1251(b)(3), if there is any amount in the excess deductions account at the close of a taxable year (determined after making any addition required under paragraph (b) of this section for such year but before making any reduction under this paragraph for such year), then the excess deductions account shall be reduced (but not below zero) by subtracting:

(i) An amount equal to (*a*) the farm net income (as defined in section 1251 (e)(3) and in paragraph (c) of § 1.1251–3) for such year, plus (*b*) the amount (as determined in subparagraph (3) of this paragraph) necessary to adjust the account for deductions for any taxable year which did not result in a reduction of the taxpayer's tax under subtitle A of the Code for such taxable year or any preceding taxable year, and

(ii) After making any addition to the excess deductions account under paragraph (b) of this section and any reduction under subdivision (i) of this subparagraph for the taxable year, an amount equal to the sum of the amounts recognized as ordinary income solely by reason of the application of section 1251(c)(1). See section 1251(b)(3)(B). Thus, no amount shall be subtracted under this subdivision for gain recognized by reason of the application of section 1245(a)(1) or 1252(a)(1). For effect on computation of farm net loss or income of gain recognized under section 1245(a)(1) upon a disposition of farm recapture property, see paragraph (b)(2) of § 1.1251–3. In the case of an installment sale of farm recapture property, the taxpayer's excess deductions account shall be reduced under this subdivision in the year of such sale by an amount equal to the gain (computed in the year of sale) to be recognized as ordinary income under section 1251(c)(1).

(2) *Examples*. The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples in which it is assumed that there is no subtraction for lack of tax benefit under subparagraph (3) of this paragraph:

Example 1. Assume the same facts as in example (3) of paragraph (b)(6) of § 1.1251–1. M's excess deductions account balance as of the close of 1975 is computed, in accordance with the additional facts assumed, in the table below:

M'S EXCESS DEDUCTIONS ACCOUNT

(1) Balance January 1, 1975		$26,000
(2) Additions for 1975		0
(3) Subtotal		26,000
(4) Subtractions for 1975 (farm net income [1])		1,000
(5) Excess deductions account limitation on gain recognized as ordinary income under section 1251(c)(1) for 1975		25,000
(6) Subtraction for disposition of farm recapture property:.		
(a) Gain from disposition of land to which section 1251(c)(1) applies (computed before applying limitation	$13,000	
(b) Gain from disposition of breeding herd to which section 1251(c)(1) applies (computed before applying limitation)	14,000	
(c) Sum of lines (a) and (b)	27,000	
(d) Excess deductions account limitation (amount in line (5))	25,000	
(e) Gain recognized as ordinary income under section 1251(c)(1) (lower of line (6)(c) or line (6)(d)		25,000
(7) Balance December 31, 1975		0

[1] Computed by treating the section 1245 gain of $6,000 under paragraph (b)(1)(ii) of § 1.1251–3 as gross income derived from the trade or business of farming.

For allocation of the $25,000 of gain recognized as ordinary income to the land and herd, and for treatment of the gain recognized in excess of $25,000 see example (3) of paragraph (b)(6) of § 1.1251–1.

Example 2. A is an unmarried individual who uses the calendar year as his taxable year. In 1971, A makes a single disposition of farm recapture property (other than land) realizing a gain of $46,000 of which $15,000 is recognized as ordinary income under section 1245(a)(1). The gain to which section 1251(c)(1) applies (computed before applying the excess deductions account limitation in section 1251(c)(2)(A) and paragraph (b)(4)(i) of § 1.1251–1) is $31,000 (i.e., $46,000 minus $15,000). The treatment of the gain realized on the disposition in excess of the $15,000 recognized as ordinary income under section 1245(a)(1) and the balance in A's excess deductions account as of the close of 1971 is computed, in accordance with the facts assumed, in the table below:

A'S EXCESS DEDUCTIONS ACCOUNT

(1) Balance January 1, 1971		$50,000
(2) Additions for 1971:		
(a) Farm net loss for 1971 [1]	$5,000	
(b) Less amount in paragraph (b)(2)(ii) of this section	25,000	
(c) Total additions for 1971		0
(3) Subtotal		50,000
(4) Subtractions for 1971		0
(5) Excess deductions account limitation on gain recognized as ordinary income under section 1251(c)(1) for 1971		50,000
(6) Subtraction for dispositions of farm recapture property:		
(a) Gain to which section 1251(c)(1) applies (computed before applying limitation)	31,000	
(b) Limitation (amount in line (5)	50,000	
(c) Gain recognized as ordinary income under section 1251(c)(1) lower of line 6(a) or line 6(b)		31,000
(7) Balance December 31, 1971	19,000	

[1] Computed by treating the section 1245 gain of $15,000 under paragraph (b)(1)(ii) of § 1.1251–3 as gross income derived from the trade or business of farming.

(3) *Amount necessary to adjust the excess deductions account with respect to deductions which did not result in a reduction of the taxpayer's tax*—(i) *In general.* Under section 1251(b)(3)(A), a subtraction is made from the excess deductions account to adjust the account for deductions that did not result in a reduction of the taxpayer's tax for the taxable year or any preceding taxable year. The amounts to be subtracted are determined under subdivisions (ii) and (iii) of this subparagraph in accordance with the rules in subdivision (iv) of this subparagraph. This subtraction shall be made before determining the amount of gain to which section 1251(c) applies. The amount subtracted under subdivision (ii) of this subparagraph is a temporary subtraction made solely to determine the amount in the excess deductions account for purposes of the limitation in section 1251(c)(2).

(ii) *Temporary subtraction.* The amount temporarily subtracted from the excess deductions account for a taxable year is the sum of the farm portion of (*a*) any net operating loss for such taxable year which does not reduce taxable income (computed without regard to the deduction under section 172(a)) in a prior year, and (*b*) any net operating loss from a prior taxable year which is carried to such taxable year but which does not reduce taxable income (computed without regard to the deduction under section 172(a)) in such taxable year.

(iii) *Permanent subtraction.* The amount permanently subtracted from the excess deductions account for a taxable year is the excess of the farm portion of any net operating loss which may be carried to the preceding year (reducing by the portion of such loss which reduced taxable income (computed without regard to the deduction under section 172(a)) for such preceding year) over the amount of such loss which may be carried to the taxable year, but the subtraction shall not be made earlier than the taxable year in which the excess deductions account is increased by reason of such loss.

(iv) *Rules of application*. For purposes of this subparagraph, the following rules shall apply:

(*a*) The farm portion of a net operating loss is that portion of such loss attributable to the trade or business of farming. Such portion and the remaining portion (hereinafter referred to as the nonfarm loss) shall be absorbed pro rata. If a farm net loss is not added to the excess deductions account in the year in which such loss occurs, the net operating loss (if any) for such year shall be treated as a nonfarm loss.

(*b*) In the case of an individual (other than a trust), the farm portion of a net operating loss shall be decreased by an amount, if any, equal to the excess of $25,000 (or the amount determined under paragraph (b)(2)(ii) of this section) over the nonfarm adjusted gross income. Such amount shall be added to the nonfarm portion of such net operating loss.

(*c*) The amounts considered as reducing taxable income under subdivision (ii) of this subparagraph in the taxable year shall be determined on the basis of a tentative computation of taxable income for such year in which the gain realized from the disposition of property to which section 1251(c)(1) applied shall be computed without regard to the excess deductions account limitation.

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

Example: A is an unmarried individual who uses the calendar year as his taxable year. For the years 1970 through 1974, A's items of income and deductions are as shown in the table below. A's personal deductions are disregarded. A had no income or loss for any year prior to 1970. Based upon such amounts and the computations shown below, A must recognize as ordinary income under section 1251(c)(1), $35,325 for 1971, $10,000 for 1972, $3,925 for 1973, and $150,000 for 1974.

Amounts assumed	1970	1971	1972	1973	1974
(a) Farm net income	($250,000)	$20,000	$5,000	($75,000)	($10,000)
(b) Nonfarm income	55,000	(82,000)	30,000	10,000	200,000
(c) Gain which would be recognized as ordinary income under 1251(c) (computed without regard to the EDA limitation) (hereinafter referred to as *farm property disposition*)		88,000	10,000	2,000	150,000
(d) Personal exemption	625	675	750	750	750
(e) Net operating loss (NOL) (computed per section 172(c))	(195,000)			(45,000)	

I. COMPUTATIONS FOR 1971

1. Excess Deductions Account (EDA) Limitation for 1971:				
a. EDA on December 31, 1970:				
1970 Farm net loss			250,000	
Less			(25,000)	
			225,000	225,000
b. Less farm net income for 1971				(20,000)
c. EDA before temporary subtraction				205,000
d. Less temporary subtraction per subdivision (ii)(*b*):				
Aggregate farm NOL carryover to 1971			195,000	
Less tentative farm NOL deduction for 1971:				
Farm net income		20,000		
Nonfarm income		(82,000)		
Farm property disposition		88,000		
Exemption		(675)		
Tentative taxable income		25,325		
Tentative NOL reducing taxable income		25,325	(25,325)	
			169,675	(169,675)
e. EDA limitation for 1971				35,325
2. 1971 Taxable Income:				
a. Farm net income				20,000
b. Nonfarm income				($82,000)
c. Farm property disposition				88,000
d. Exemption				(675)

Amounts assumed	1970	1971	1972	1973	1974
e. Section 1202 deduction:					
Farm property disposition				$88,000	
Less amount treated as ordinary income under section 1251(c) (lesser of amount of gain on line 1(e))				35,325	
Capital gain				52,675	
Less 50 percent deduction				26,337	(26,338)
f. 1971 Taxable income					(1,013)
II. COMPUTATIONS FOR 1972					
1. Excess Deductions Account Limitation for 1972:					
a. EDA (line 1(c) above)					205,000
b. Less recapture in 1971					(35,325)
c. Less farm net income for 1972					(5,000)
d. Less permanent subtraction per subdivision (iii):					
1970 Farm NOL carryover to 1971				195,000	
Less 1970 farm NOL carryover to 1972 (computed per section 172(b)(2)):					
Farm NOL to 1971			$195,000		
Less 1971 taxable income computed per section 172(b)(2):					
Farm net income		$20,000			
Nonfarm income		(82,000)			
Farm property disposition		88,000			
		26,000	(26,000)		
Farm NOL carryover to 1972		169,000	($169,000)		
				26,000	($26,000)
e. EDA before making temporary subtractions					138,675
f. Less temporary subtraction per subdivision (ii)(*b*):					
Farm NOL carryover to 1972				169,000	
Farm net income			5,000		
Nonfarm income			30,000		
Farm recapture disposition			10,000		
Exemption			(750)		
Tentative taxable income			44,250		
Tentative NOL reducing taxable income			44,250	(44,250)	
				124,750	(124,750)
g. EDA limitation for 1972					13,925
2. Taxable Income for 1972:					
a. Farm net income					5,000
b. Nonfarm income					30,000
c. Farm property disposition					10,000
d. Exemption					(750)
e. Section 1202 deduction:					
Farm property disposition				10,000	
Less amount treated as ordinary income under section 1251(c) (lesser of amount of gain on line 1(g))				10,000	0
f. Taxable income before NOL deduction					44,250
g. Net operating loss deduction					(44,250)
h. Taxable income for 1972					0
III. COMPUTATIONS FOR 1973					
1. Excess Deductions Account Limitation for 1973:					
a. Line 1(e) above					138,675
b. Less recapture in 1972					(10,000)
c. Less permanent subtraction per subdivision (iii):					
1970 Farm NOL carryover to 1972			169,000		
Less 1970 Farm NOL reducing taxable income in 1972			(44,250)		
			124,750	124,750	
Less 1970 Farm NOL carryover to 1973 computed per section 172(b)(2):					
Farm NOL to 1972			169,000		

Amounts assumed	1970	1971	1972	1973	1974
1972 Taxable income computed per section 172(b)(2):					
Farm net income		$5,000			
Nonfarm income		30,000			
Farm recapture disposition		10,000			
		45,000	($45,000)		
Farm NOL carryover to 1973			124,000	($124,000)	
				750	($750)
d. EDA before making temporary subtractions					$127,925
e. Less temporary subtraction per subdivision (ii)(*a*)–zero (since 1973 farm loss treated as nonfarm addition to NOL per subdivision (iv)(*a*))					0
f. Less temporary subtraction per subdivision (ii)(*b*): Aggregate farm NOL carryover to 1973				$124,000	
Less tentative farm NOL deduction for 1973:					
Farm net income			($75,000)		
Nonfarm income			10,000		
Farm property disposition			30,000		
Exemption			(750)		
Tentative taxable income			(44,250)		
Tentative NOL reducing taxable income			0	0	
				124,000	(124,000)
g. EDA limitation for 1973					3,925
2. Taxable Income 1973:					
a. Farm net income					(75,000)
b. Nonfarm income					10,000
c. Farm property disposition					20,000
d. Exemption					(750)
e. Section 1202 deduction:					
Farm property disposition				20,000	
Less amount treated as ordinary income under section 1251(c) (lesser of amount of gain on line 1(g))				3,925	
Capital gain				16,075	
Less 50 percent deduction				8,038	(8,037)
f. Taxable income for 1973					(53,787)
IV. COMPUTATIONS FOR 1974					
1. Excess Deductions Account Limitation for 1974:					
a. Line 1(d) above					127,925
b. Less recapture in 1973					(13,925)
c. Farm loss for 1974			10,000		
Plus farm NOL deduction (see § 1.1251–3(b)(3))			45,000		
			55,000	55,000	
Less				25,000	
				30,000	30,000
d. Less permanent subtraction per subdivision (iii):					
1970 Farm NOL carryover to 1973				124,000	
Less 1970 farm NOL carryover to 1974 per section 172(b)(2)				124,000	
				0	0
e. EDA before making temporary subtractions					154,000
f. Less temporary subtraction per subdivision (ii)(*b*):					
Aggregate farm NOL carryover to 1974				124,000	
Less tentative farm NOL deduction in 1974:					
Farm net income			(10,000)		
Nonfarm income			200,000		
Farm property disposition			150,000		
Exemption			(750)		
Tentative taxable income			339,250		
Tentative NOL deduction			169,000		

Amounts assumed	1970	1971	1972	1973	1974
Farm portion of tentative NOL deduction				124,000	
				0	0
g. EDA limitation for 1974					$154,000
2. Taxable Income 1974:					
a. Farm net income					(10,000)
b. Nonfarm income					200,000
c. Farm property disposition					150,000
d. Exemption					(750)
e. Section 1202 deduction:					
Farm property disposition				$150,000	
Less amount treated as ordinary income under section 1251(c) (lesser of amount of gain on line 1(g))				150,000	0
f. Taxable income before NOL deduction					339,250
g. Net operating loss deduction					(169,000)
h. Taxable income					170,250

(vi) *Electing small business corporation.* *(a)* In the case of an electing small business corporation, the amounts to be subtracted under subdivisions (ii) and (iii) of this subparagraph, shall be the sum of the amounts under such subdivisions computed with respect to each shareholder of the corporation for the taxable year of the shareholder with which or within which the taxable year of the corporation ends, by applying (*b*) of this subdivision (vi), in lieu of subdivision (iv)(*a*) of this subparagraph.

(*b*) For purposes of (*a*) of this subdivision, the farm portion of a shareholder's net operating loss is that portion of the net operating loss of such shareholder attributable to the corporation's farm net loss, and such portion and the remaining portion shall be considered to be absorbed pro rata. If a corporation's farm net loss is not added to its excess deduction account in the year in which such loss occurs, no portion of a shareholder's net operating loss for the taxable year of the shareholder with which or within which such taxable year of the corporation ends shall be attributable to such corporation's farm net loss.

(d) *Exception for taxpayers using certain accounting methods*—(1) *General rule.* Under section 1251(b)(4), except to the extent that a taxpayer has succeeded to an excess deductions account as provided in paragraph (e) of this section (relating to receipt of farm recapture property in certain corporate and gift transactions), additions to the account shall not be required by a taxpayer who elects to compute taxable income from the trade or business of farming (as defined in paragraph (e)(1) of § 1.1251–3:

(i) By using inventories for all property which may be inventoried except as to property to which subdivision (ii) of this subparagraph applies, and

(ii) In accordance with subparagraph (3) of this paragraph, by charging to capital account all expenditures paid or incurred which are properly chargeable to capital account including such expenditures which the taxpayer may, under chapter 1 of the Code or regulations prescribed thereunder, otherwise treat or elect to treat as expenditures which are not chargeable to capital account.

For rules as to procedure of making the election, effect of a change in method of accounting upon making the election, and conditions for revoking the election, see subparagraphs (4), (5), and (6), respectively, of this paragraph.

(2) *Inventories.* The absence of property which may be inventories shall not preclude a taxpayer from making an election under section 3251(b)(4). Any acceptable inventory method will satisfy the requirement of subparagraph (1)(i) of this paragraph.

(3) *Property chargeable to capital account*—(i) *In general.* Property subject to the capitalization requirement prescribed in subparagraph (1)(ii) of this paragraph includes all property described in section 1231(b) (1) and (3),

without regard to any holding period therein provided, which is used in the trade or business of farming. Thus, for example, property subject to the capitalization requirement includes property used in the trade or business of farming of a character subject to the allowance for depreciation and real property so used regardless of the period held, and livestock used in the trade or business of farming which is held for draft, breeding, dairy, or sporting purposes regardless of the period held.

(ii) *Expenditures which must be capitalized.* Expenditures subject to the requirement of subparagraph (1)(ii) of this paragraph are all expenditures, whether direct or indirect, paid or incurred, which are properly chargeable to capital account. For examples of the meaning of the term *properly chargeable to capital account,* see §§ 1.61–4, 1.162–12, 1.263(a)–1, and 1.263(a)–2, and paragraph (a)(4) (ii) and (iii) of § 1.446–1. Other examples of expenditures referred to in subparagraph (1)(ii) of this paragraph are expenditures under sections 175 (relating to soil and water conservation), 180 (relating to fertilizer, etc.), 182 (relating to land clearing), and 266 (relating to certain carrying charges) which (without regard to section 1251) a taxpayer may treat or elect to treat as expenditures which are not chargeable to capital account. Thus, for example, with respect to developing a farm, ranch, orchard, or grove, amounts properly chargeable to capital account include amounts paid or incurred for upkeep, taxes, interest, and other carrying charges, water for irrigation, fertilizing, controlling undergrowth, and the cultivating and spraying of trees. For a further example, with respect to a produced animal, amounts properly chargeable to capital account for the animal include all expenditures paid or incurred for producing the animal, such as for stud, breeding, and veterinary services, as well as all amounts paid or incurred with respect to the brood animal during the gestation period of the produced animal including all amounts paid or incurred for feed, maintenance, utilities, indirect overhead, depreciation, insurance, and carrying charges. Direct and indirect expenditures properly chargeable to capital account with respect to raising an animal may include, in addition to expenditures for feed, maintenance, etc., expenditures for training. Direct and indirect expenditures with respect to feed may include, in the case of a grazing operation, fees for the rental of grazing land, and the portion of all labor, taxes, interest, fencing costs, and carrying charges paid or incurred by the taxpayer allocable to grazing. For purposes of this subparagraph, reasonable allocations shall be made by the taxpayer of items between animals held for different purposes and as to each animal held. However, all amounts allocated to a brood animal during the period of gestation are, for purposes of this subparagraph, entirely chargeable to the capital of the produced animal.

(iii) *Unharvested crops.* With respect to unharvested crops to which section 1231(b)(4) applies, see section 268 and paragraph (g) of § 1.1016–5 (relating, respectively, to disallowance of certain deductions and to adjustments to basis).

(iv) *Changes in character of property.* If, in a taxable year subsequent to the first taxable year to which an election under section 1251(b)(4) applies, property which was not subject to the requirements of subparagraph (1)(ii) of this paragraph becomes subject to such requirements, then the following rules shall apply:

(*a*) The adjusted basis of such property at the beginning of the taxable year in which it becomes subject to the requirements of subparagraph (1)(ii) of this paragraph shall be equal to the amount its adjusted basis would have been on such date had it been accounted for in accordance with such requirements (taking into account, if applicable, the depreciation which would have been allowed as determined by the taxpayer using a period, salvage value, and methods that would have been proper).

(*b*) At the beginning of the taxable year in which such property becomes subject to the requirements of subparagraph (1)(ii) of this paragraph:

(*1*) If such property was not included in the opening inventory, the amount equal to the excess of its adjusted basis as computed in (*a*) of this subdivision

over its adjusted basis as of the close of the preceding taxable year, or

(*2*) If such property was included in the opening inventory, such opening inventory shall be reduced by the inventory value of such property included therein and the amount of the difference between the adjusted basis for the property computed in (*a*) of this subdivision and such inventory value,

Shall be added to gross income for such taxable year and shall be treated as gross income derived from the trade or business of farming under paragraph (b)(1)(ii) of § 1.1251–3, except that if the difference in (*b)(2*) of this subdivision represents an excess of such inventory value over the adjusted basis for the property computed in (*a*) of this subdivision then such excess shall be subtracted from gross income for such taxable year and shall be treated as a deduction allowed which is directly connected with carrying on the trade or business of farming under paragraph (b)(1)(i) of § 1.1251–3.

(*c*) If any deductions for depreciation are treated as amounts which would have been allowed in a prior taxable year or years for purposes of (*a*) of this subdivision, such deduction shall be treated as having been allowed for purposes of applying sections 1245 and 1250 in the same taxable year or years and thus included in the amount of adjustments reflected in adjusted basis within the meaning of paragraph (a)(1)(ii) of § 1.1245–2 or depreciation adjustments within the meaning of paragraph (d)(1) of § 1.1250–2 (as the case may be).

(*d*) For purposes of this subparagraph (3), if during a taxable year property becomes subject to the requirements of subparagraph (1)(ii) of this paragraph, it shall be considered subject to such requirements on each day it is held during such year.

(*e*) The adjusted basis under (*a*) of this subdivision of property of a character subject to the allowance for depreciation shall be its basis for which deductions may be computed under section 167.

(v) *Example*. The provisions of subdivision (iv) of this subparagraph may be illustrated by the following example:

Example: On January 1, 1974, A, an individual taxpayer who in a previous year had elected under section 1251(b)(4) to compute income from the trade or business of farming by using inventories and by charging to capital account all items properly chargeable to capital under the rules of subdivision (ii) of this subparagraph, purchases a herd of six-month-old feeder calves for $13,000. During 1974, in connection with such herd, A incurred raising costs of $4,000 and carrying charges of $1,600 which would have been properly chargeable to capital account within the meaning of subparagraph (1)(ii) of this paragraph if the herd had not been included in inventory. A determines under his unit-livestock method that on December 31, 1974, the inventory value of the herd is $17,000. On March 1, 1975, A decides to use one-half of the herd for breeding purposes with such part of the herd becoming subject to the capitalization requirements. On January 1, 1975, the adjusted basis for the animals held for breeding purposes, computed under the provisions of subdivision (iv)(a) of this subparagraph, is $9,300 (that is, the aggregate of one-half of the purchase price of $13,000 for the entire herd of feeder calves, $6,500, one-half of the carrying charges of $1,600 incurred during 1974 in connection with the entire herd, $800, and one-half of the $4,000 of raising costs incurred during 1974 for the entire herd, $2,000). There is no adjustment for the depreciation which would have been allowed since no animal in the herd had reached an acceptable breeding age. Therefore, A as of January 1, 1975, must under the provisions of subdivision (iv)(*b)(2*) of this subparagraph subtract $8,500 from his opening inventory value of $17,000. However, A has not changed his method of accounting with respect to such animals. Under the provisions of subdivision (iv)(*b)(2*) of this subparagraph, A for 1975 will add $800 to his gross income (that is, the difference between the adjusted basis for the calves to be used for breeding purposes, $9,300, over the inventory value of such animals, $8,500). Such amount under the provisions of subdivision (iv)(*b*) shall be treated as gross income derived from the trade or business of farming under paragraph (b)(1) of § 1.1251–3.

(4) *Time and manner of making election*—(i) *In general*. The election under section 1251(b)(4) for any taxable year beginning after December 31, 1969, shall be filed within the time prescribed by law (including extensions thereof) for filing the return for such taxable year. Such election shall be made and filed by attaching a statement of such election signed by the taxpayer to the return for the first taxable year for which the election is made. The statement shall contain a declaration that the taxpayer is making an election

under section 1251(b)(4) of the Code and that taxable income from the trade or business of farming is computed by using inventories for all property, which may be inventoried and by charging to capital account all expenditures paid or incurred which are properly chargeable to capital account (including such expenditures which the taxpayer may, under chapter 1 of the Code or regulations prescribed thereunder, otherwise treat or elect to treat as expenditures which are not properly chargeable to capital account). Additionally, the statement must contain the information prescribed by subparagraph (5) of this paragraph, if applicable.

(ii) *Joint return*. If for a taxable year taxpayers file a joint return under section 6013, the election referred to in subparagraph (1) of this paragraph must be made by both such taxpayers in accordance with the provisions of subdivision (i) of this subparagraph. If, however, in such case either of such taxpayers has for a previous taxable year made such an election, then only the taxpayer who has not made such election is required to comply with the provisions of subdivision (i) of this subparagraph. The taxpayer who previously made such an election shall attach a statement to the return specifying the taxable year for which the election was made and with whom the election was filed.

(5) *Change in method of accounting, etc.*—(i) *In general*. If, in order to comply with an election made under section 1251(b)(4), a taxpayer must change his method of accounting (in computing taxable income from the trade or business of farming) by placing in inventory a class of items not previously treated as in an inventory or by charging to capital account a class of items which had been consistently treated as an expense or as part of inventory (see paragraph (e)(2)(ii)(*b*) of §1.446–1), the taxpayer will be deemed to have obtained the consent of the Commissioner as to such change in method of accounting solely as to such items and there shall be taken into account in accordance with section 481 of the Code and the regulations thereunder those adjustments which are determined to be necessary by reason of such change solely as to such items in order to prevent amounts from being duplicated or omitted. For purposes of section 481(a)(2), such change in method of accounting with respect to only such items shall be treated as a change not initiated by the taxpayer and, thus, under paragraph (a)(2) of §1.481–1, no part of the adjustments required under section 481 with respect to such items shall be based on amounts which are taken into account in computing income (or which should have been taken into account had the new method of accounting been used) for taxable years beginning before January 1, 1954, or ending before August 17, 1954.

(ii) *Additional information*. If, in order to comply with an election made under subparagraph (1) of this paragraph a taxpayer (or in the case of a joint return one or both taxpayers) changes his method of accounting, then in addition to the information required to be filed under subparagraph (4) of this paragraph the taxpayer must file on Form 3115 as part of such election all the information described in paragraph (e)(3) of §1.446–1 (relating to change in method of accounting), but the time prescribed in paragraph (e)(3) of §1.446–1 for filing Form 3115 shall not apply.

(iii) *Election made before May 7, 1976*. If an election referred to in subparagraph (1) of this paragraph was made before May 7, 1976, the taxpayer shall file not later than August 5, 1976, such information referred to in subparagraph (4) of this paragraph not previously required by applicable regulations to be filed in order to make such election, and, in addition, if subdivision (ii) of this subparagraph applies, the taxpayer shall file not later than August 5, 1976, on Form 3115 the information referred to in subdivision (ii) of this subparagraph with the district director, or the director of the internal revenue service center, with whom the election was filed. For this purpose, Form 3115 shall be attached to a statement clearly identifying the election referred to in subparagraph (1) of this paragraph and the first taxable year to which it applied.

(6) *Revocability of election*—(i) *In general*. An election referred to in subparagraph (1) of this paragraph is binding on the taxpayer or in the case of a

joint return both taxpayers) for the taxable year of such election and for all subsequent taxable years (regardless of whether they continue to file a joint return) and may not be revoked except with the consent of the Commissioner. Since revocation would constitute a change in method of accounting, in order to secure the Commissioner's consent to the revocation of such an election and to a change of the taxpayer's method of accounting, all the provisions of paragraph (e)(3) of §1.446–1 must be met including the requirement that Form 3115 must be filed within 180 days after the beginning of the taxable year in which it is desired to make the change. See section 481 and the regulations thereunder (relating to certain adjustments required by such changes).

(ii) *Revocation of elections made prior to May 7, 1976.* If on or before May 7, 1976, an election under section 1251(b)(4) has been made, such election may be revoked without permission of the Commissioner by filing on or before August 5, 1976, with the district director or the director of the internal revenue service center with whom the election was filed a statement of revocation of an election under section 1251(b)(4). If such election to revoke is for a period which falls within one or more taxable years for which an income tax returns shall be filed for any such taxable years for which the computation of taxable income is affected by reason of such revocation.

(e) *Transfer of excess deductions account*—(1) *Certain corporate transactions*—(i) *In general.* Under section 1251(b)(5)(A), in the case of a transfer described in section 1251(d)(3) and paragraph (c)(2) of §1.1251–4 to which section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings), 374(a) (relating to exchanges pursuant to certain railroad reorganizations), or 381 (relating to carryovers in certain corporate acquisitions) applies, the acquiring corporation shall succeed to and take into account as of the close of the day of distribution or transfer the excess deductions account of the transferor. Determinations under this subdivision shall be made under subdivisions (ii), (iii), and (iv) of this subparagraph regardless of whether section 381 applies. For treatment as farm recapture property of stock or securities received in certain transfers to controlled corporations to which section 1251(d)(3) (but not section 1251(b)(5)(A)) applies, see section 1251(d)(6) and paragraph (f) of §1.1251–4.

(ii) *Acquiring corporation.* For purposes of subdivision (i) of this subparagraph, determinations as to which corporation is the acquiring corporation shall be made under paragraph (b)(2) of §1.381(a)–1.

(iii) *Certain operating rules.* For purposes of subdivision (i) of this subparagraph, the operating rules of section 381(b) and §1.381(b)–1 shall apply. Thus, for example, except in the case of a reorganization qualifying under section 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of section 368(a)(1)), the amount of the excess deductions account of the transferor shall be computed, as of the close of the date of distribution or transfer (as determined under paragraph (b) of §1.381(b)–1), as if the taxable year of the transferor closed on such date (regardless of whether the taxable year actually closed). In the case of a reorganization qualifying under section 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of section 368(a)(1)), the acquiring corporation's excess deductions account shall be treated for purposes of section 1251 just as the transferor corporation's excess deductions account would have been treated if there had been no reorganization.

(iv) *Excess deductions account balance.* For purposes of subdivision (i) of this subparagraph, the amount in the transferor's excess deductions account as of the close of the date of distribution or transfer referred to in subdivision (iii) of this subparagraph shall be the amount in such account determined after making all the applicable additions and subtractions under section 1251(b) (other than subtractions under paragraph (5)(A) of section 1251(b) and this subparagraph) for the taxable year ending (or considered ending) on such date including a subtraction by reason of gain (if any) recognized under section 1251(c)(1) by reason of a disposition

which is in part a sale or exchange and in part a gift transaction to which section 1251(d)(1) and paragraph (a)(2) of § 1.1251–4 apply.

(2) *Certain gifts*—(i) *In general*. If farm recapture property is disposed of by gift (including for purposes of this paragraph in a transaction which is in part a sale or exchange and in part a gift or a transaction treated under paragraph (a)(2) of this section as a gift), and if such gift is made during any *1-year period* (described in subdivision (ii) of this subparagraph) for which the *potential gain limitation percentage* (as computed in subdivision (iii) of this subparagraph) exceeds 25 percent, then the provisions of subdivision (iv) of this subparagraph shall apply in respect of such gift.

(ii) *One-year period*. For purposes of this subparagraph, a *1-year period* is a period of 365 days beginning on the date a gift is made by the donor.

(iii) *Potential gain limitation percentage*. Under this subdivision, the *potential gain limitation percentage* for any such 1-year period is a percentage equal to (*a*) the sum of the potential gains (determined as of the first day of such period) on each item of farm recapture property held by such taxpayer on such first day disposed of by gift by the taxpayer during such period, divided by (*b*) the sum of the potential gains (determined as of the first day of such period) on all farm recapture property held by such taxpayer on such first day.

(iv) *Allocation ratio*. With respect to each gift of property (to which the provisions of this subdivision apply) made during a taxable year, each donee shall succeed (at the time the first of such gifts is made during such taxable year) to the same proportion of (*a*) the donor's excess deductions account determined, as of the close of such taxable year of the donor, after making all the applicable additions and subtractions under section 1251(b) (other than subtractions under section 1251(b)(5) and this paragraph), as (*b*) the potential gain (determined immediately prior to the time the first of such gifts is made during such taxable year) on the property (held by the donor immediately prior to such time) received by such donee bears to (*c*) The aggregate potential gain (determined immediately prior to such time) on all farm recapture property held by the donor immediately prior to such time.

(v) *Definitions and certain special rules*. For purposes of this subparagraph:

(*a*) The term *potential gain* means an amount equal to the excess of the fair market value of property over its adjusted basis, but, in the case of land, limited under paragraph (b)(2)(ii) of § 1.1251–1 to the extent of the deductions allowable in respect of such land pursuant to an election (if any) under sections 175 (relating to soil and water conservation expenditures) and 182 (relating to expenditures by farmers for clearing land) for the taxable year of disposition and the four immediately preceding taxable years regardless of whether any such preceding taxable year begins before December 31, 1969. See section 1251(e)(5).

(*b*) Property held on the first day of a one-year period shall include property received by gift during such one-year period and the potential gain with respect to such property, for purposes of making the computations under this subparagraph, shall be the potential gain in the hands of the donor reduced by the amount of gain (in the case of an exchange which is part a sale and part a gift) taken into account by the donor.

(*c*) Property held by a taxpayer on the first day of a one-year period which property becomes farm recapture property in the hands of such taxpayer during such one-year period shall be considered to be farm recapture property on each day of such one-year period.

(vi) *Part-sale-part-gift transaction*. If property is disposed of in a transaction which is in part a sale or exchange and in part a gift, then for purposes of subdivisions (iii)(*a*) and (iv)(*b*) of this subparagraph the potential gain with respect to the property transferred shall be reduced by the amount of gain taken into account by the transferor.

(vii) *Joint return*. For application of the provisions of this subparagraph with respect to a taxable year for which a joint return is filed, see paragraph (f)(4) of this section.

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

in which it is assumed that all taxpayers are unmarried individuals.

Example 1. The only farm recapture property A owns is a farm, consisting of farm land and certain farm equipment which is farm recapture property. During the period involved, there was no deduction allowable under section 175 or 182 to any person owning an interest in the farm. A, who uses the calendar year as his taxable year, makes a series of gifts of undivided interests in the farm. In these circumstances, computations may be made by reference to percentages of undivided interests in the farm. The potential gain limitation percentages for each applicable 1-year period are computed, in accordance with the additional facts assumed, in the table below:

Date Gift to donee	9/1/70	8/1/71	3/1/72	5/1/73
	C	D	E	F
(1) Percent of undivided interest in entire farm given as gift by A on date indicated	20%	10%	10%	60%
(2) Percent of undivided interest in entire farm held by A immediately before gift	100%	80%	70%	60%
(3) Potential gain:.				
(a) On all property held by A on date of gift	$100,000	$96,000	$140,000	$125,000
(b) Limitation percentage (sum of amounts in line (1) during 1-year period beginning on date of gift divided by line (2))	30%	25%	14.28%	100%

(ii) Under subparagraph (2)(iv) of this paragraph, C, D, and F each succeed to the proportion of A's excess deductions account at each applicable time as computed in accordance with the additional facts assumed, in the table below:

	Taxable year ending—			
	Dec. 31, 1970	Dec. 31, 1971	Dec. 32, 1972	Dec. 31, 1973
Gift to donee to which subparagraph (2)(iv) of this paragraph applies during taxable year	C	D	E	F
(4) Potential gain (determined immediately prior to time first gift to which subparagraph (2)(iv) of this paragraph applies is made):				
(a) On property received by donee to which such subparagraph (2)(iv) applies (line (3)(a) multiplied by line (1) divided by line (2))	$20,000	$12,000	.....	$125,000
(b) Aggregate potential gain on all farm recapture property held by donor (line (3)(a))	$100,000	$96,000	.....	$125,000
(5) Allocation ratio (line (4)(a), divided by line (4)(b))	20%	12.5%	.....	100%
(6) Excess deductions account of A:.				
(a) At end of previous taxable year	0	$160,000	$210,000	$200,000
(b) Net increase (decrease) for taxable year (determined before making any subtractions under section 1251(b)(5) and this paragraph)	$200,000	$80,000	($10,000)	$36,000
(c) At 12/31 (so determined)	$200,000	$240,000	$200,000	$236,000
(d) Less: Portion to which donee succeeds (line (5), multiplied by line (6)(c))	$40,000	$30,000	$0	$236,000
(e) At 12/31 (to line (6)(a) following taxable year)	$160,000	$210,000	$200,000	$0

Since the potential gain limitation percentage for the 1-year period beginning on September 1, 1970, exceeds 25 percent, a portion of A's excess deductions account, under the provisions of subparagraph (2)(iv) of this paragraph, is succeeded to by C and D. Similarly, since such percentage for the 1-year period beginning May 1, 1973, exceeds 25 percent, such provisions apply to the gift made to F. Since, however, such percentage is 25 percent or less for all 1-year periods in which the gift to E falls (i.e., 25 percent and 14.28 percent for the 1-year periods beginning, respectively, on August 1, 1971, and March 1, 1972) such provisions do not apply to the gift to E.

Example: 2. (i) G uses the calendar year as his taxable year and H uses a taxable year ending June 30. As of the close of 1972, G has $100,000 in his excess deductions account, determined before any subtractions under section 1251(b)(5) and this paragraph. G owns only three items of farm recapture property, none of which is land. On May 1, 1972, G makes a gift of farm recapture property No. 1 to his son and on September 1, 1972, G sells to H for $80,000 farm recapture property No. 2 in a transaction which is in part a sale and in part a gift. G owns throughout all relevant periods farm recapture property No. 3. The potential gain limitation percentage for G's one-year period beginning May 1, 1972, is

computed in accordance with the additional facts assumed in the table below:

	Farm Recapture Property			Total
	No. 1	No. 2	No. 3	
(1) Fair market value 5/1/72	$25,000	$100,000	$800,000	
(2) Adjusted basis 5/1/72	$10,000	$60,000	$795,000	
(3) Potential gain (line (1), minus line (2))	$15,000	$40,000	$5,000	$60,000
(4) Sum of potential gains on properties disposed of by gift during period less gain taken into account by transferor on part-sale-part-gift	$15,000	$20,000	.....	$35,000
(5) Potential gain limitation percentage (total line (4), divided by total line (3))	.....	.....	.....	58⅓%

Since the potential gain limitation percentage for the one-year period beginning on May 1, 1972, exceeds 25 percent, the provisions of subparagraph (2)(iv) of this paragraph apply to the gift to the son and that portion of the disposition to H which is a gift.

(ii) The portion of G's excess deductions account determined, as of the close of 1972, before any subtraction under section 1251(b)(5) and this paragraph, allocated to the son and to H as of May 1, 1972, is computed in the table below:

	Property			Total
	No. 1	No. 2	No. 3	
(1) Potential gain under part (i) of this example (since the first day of the one-year period is the same as the time as of which the first gift was made during the taxable year)	$15,000	$40,000	$5,000	$60,000
(2) Potential gain less amount taken into account by transfer on part-sale-part-gift	15,000	20,000	.....	.....
(3) Allocation percentage (line (2), divided by $60,000)	25%	33⅓%	.....	.....
(4) Excess deductions account at close of taxable year (determine before making any subtractions under section 1251(b)(5) and this paragraph)	.....	.....	.....	100,000
(5) Portion to which donee succeeds on 5/1/72	25,000	33,333	.....	58,333
(6) G's excess deductions account 12/31/72	.....	.....	.....	$41,667

Accordingly, the amount of G's excess deduction account succeeded to as of May 1, 1972, is $25,000 by the son and $33,333 by H.

(f) *Joint return*—(1) *Joint excess deductions account*. If for a taxable year a taxpayer and his spouse file a joint return under section 6013, then for such taxable year each taxpayer shall (if necessary) establish and maintain a joint excess deductions account. Such joint excess deductions account shall consist of the aggregate of the separately maintained excess deductions account of each spouse. A separately maintained excess deductions account shall be computed under the rules of paragraphs (b) and (c) of this section, except that for each taxable year a joint return is filed:

(i) The $50,000 amount in the nonfarm adjusted gross income limitation in paragraph (b)(2)(i) of this section shall be considered satisfied if the combined nonfarm adjusted gross income of both spouses exceeds $50,000,

(ii) The $25,000 amount in the farm net loss exclusion in paragraph (b)(2)(ii) of this section shall be allocated between the two spouses in proportion to the farm net loss of each spouse having a farm net loss, and

(iii) The separately maintained excess deductions account of each spouse shall be reduced, if necessary, below zero, by the amount of such spouse's farm net income (computed as if a separate return were filed) plus the amount of gain (computed under subparagraph (3) of this paragraph) which is recognized as ordinary income under section 1251(c)(1) in respect of a disposition of farm recapture property owned by the taxpayer.

(2) *Surviving spouse*. For purposes of this paragraph, a joint return does not include a return of a surviving spouse (as defined in section 2 relating to a spouse who died during either of his two taxable years immediate preceding the taxable year) which is treated as a joint return of a husband and wife under section 6013.

(3) *Application of excess deductions account limitation in joint return year.* In the case of a taxable year for which a joint return is filed, the aggregate of the amount of gain recognized as ordinary income under section 1251(c)(1) (after applying paragraph (b) (2)(o) and (3) of § 1.125–1, if applicable) shall not exceed the amount in the joint excess deductions account (that is, the aggregate of the separately maintained excess deductions account of each spouse) at the close of the taxable year after subtracting from each such separately maintained account the amount specified in section 1251(b) (3) (A) and paragraph (c) (1) (i) of this section as modified by the rules of this paragraph. For the amount of limitation for a taxable year for which a separate return is filed, see paragraph (b)(4) of this section. For determinations as to which dispositions are taken into account for any taxable year, see paragraph (b)(4) of § 1.1251–1.

(4) *Certain gifts*—(i) *In general.* If farm recapture property is transferred as a gift by a spouse to a person other than a spouse during a taxable year for which a joint return is filed, the spouses shall for purposes of applying the provisions of section 1251(b) (5) (B) and paragraph (e)(2) of this section be treated as a single taxpayer. Thus, under paragraph (e)(2) of § 1.1251–2, the potential gain limitation percentage and the proportion for allocating the amount in the joint excess deductions account to one or more donees shall be determined by treating the spouses as a single taxpayer. However, with respect to each gift by a spouse, such spouse's separately maintained excess deductions account shall be reduced (below zero, if necessary) by the amount of the joint excess deductions account balance to which the donee of such gift succeeded under paragraph (e)(2)(iv) of this section.

(ii) *Gift between spouses.* If farm recapture property is transferred by gift by one spouse to another spouse during a taxable year for which a joint return is filed, such gift shall not affect the balance in the joint excess deductions account but its effect on the separately maintained excess deductions account of each spouse shall be determined as if separate returns were filed, but only after applying subdivision (i) of this subparagraph.

(5) *Allocation of joint excess deductions account upon filing separate returns*—(i) *In general.* If for any reason a taxpayer and his spouse cease to file a joint return, then except as provided in this subparagraph the amount of the separately maintained excess deductions account of each spouse as of the close of the last taxable year for which a joint return was filed shall be the amount of such spouse's excess deductions account as of the beginning of the first taxable year for which they cease filing a joint return.

(ii) *Deficit.* If under subparagraph (4)(i) of this paragraph one of the spouses has a deficit in his separately maintained excess deductions account as of the close of the last taxable year for which a joint return was filed, then as of the beginning of the first taxable year for which they cease filing a joint return:

(*a*) The spouse who had such deficit shall have an excess deductions account of zero, and

(*b*) The other spouse shall have an excess deductions account equal to the amount prescribed in subdivision (i) of this subparagraph minus the amount of such deficit.

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

Example 3. Assume the same facts as in example (4) of paragraph (b)(5) of this section, except that H and W file a joint return under section 6013 and that H has a farm net loss of only $40,000. Thus, since the nonfarm adjusted gross income for calendar year 1971 was $60,000 for H and $30,000 for W, their combined nonfarm adjusted gross income exceeds $50,000, thereby satisfying under subparagraph (1)(i) of this paragraph the $50,000 limitation of paragraph (b)(2)(i) of this section. Assume further that for 1971 only W makes a dispostion of farm recapture property (other than land and section 1245 property). As a result of such disposition, W realizes a gain of $14,000. Accordingly, for 1971, the separately maintained excess deductions accounts of H and W, their joint excess deductions account, and the treatment of the gain realized by W on the disposition of the farm recapture property are computed, in accordance with the facts assumed in the table below:

EXCESS DEDUCTIONS ACCOUNTS

		H's		W's		Joint
(1) Balance Jan. 1, 1971	.....	$10,000	.....	$5,000	.....	$15,000
(2) Additions for 1971:						
(a) Farm net loss for 1971	$40,000	.....	$10,000	.....	$50,000	.....
(b) Less amount in paragraph (b)(2)(ii) of this section as allocated under subparagraph (1)(ii) of this paragraph	20,000	.....	5,000	.....	25,000	.....
(c) Total additions for 1971	.....	20,000	.....	5,000	.....	25,000
(3) Subtotal	.....	30,000		10,000	.....	40,000
(4) Subtractions for 1971	.....	0	.....	0	.....	
(5) Excess deductions account limitation on gain recognized as ordinary income under section 1251(e)(1) for 1971	.....	30,000	.....	10,000	.....	40,000
(6) Subtraction for dispositions of farm recapture property:						
(a) Gain to which section 1251(c)(1) applies (computed before applying limitation)	0	.....	14,000	.....	14,000	.....
(b) Limitation (amount in line (5))	30,000	.....	10,000	.....	40,000	.....
(c) Gain recognized as ordinary income under section 1251(c)(1), computed for joint account (lower of line 6(a) or line 6(b) subject to provisions as to separately maintained accounts of subparagraph (1)(iii)	.....	.....	.....	14,000	.....	14,000
(7) Balance Dec. 31, 1971	.....	30,000	.....	(4,000)	.....	26,000

If for 1972, H and W were to file separate returns, then the separately maintained excess deductions account balances as of January 1, 1972, would be $26,000 and zero respectively. See subparagraph (5)(ii) of this paragraph.

[T.D. 7418, 41 FR 18816, May 7, 1976; 41 FR 23669, June 11, 1976]

§ 1.1251–3 Definitions relating to section 1251.

(a) *Farm recapture property*—(1) *In general*. (i) The term *farm recapture property* means any property (other than section 1250 property as defined in section 1250(c)) which, in the hands of the taxpayer is or was property:

(*a*) Which is described in section 1231(b)(1) (relating to business property held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), section 1231(b)(3) (relating to livestock), or section 1231(b)(4) (relating to an unharvested crop), and

(*b*) Which, at the time the property qualifies under (*a*) of this subdivision, is used in the trade or business of farming (as defined in paragraph (e) of this section).

(ii) The term *farm recapture property* also includes:

(*a*) Property acquired by gift and property acquired in a transaction to which section 1251(b)(5)(A) applies, if such property was farm recapture property within the meaning of subdivision (i) of this subparagraph in the hands of the transferor, and

(*b*) Property the basis of which in the hands of the taxpayer holding such property is determined by reference to the basis of other property which in the hands of such taxpayer was farm recapture property within the meaning of subdivision (i) of this paragraph. For purposes of (*b*) of this subdivison (ii) property whose basis is determined in accordance with the last sentence of section 1033(c) shall be considered as having as basis determined by reference to the property whose conversion gave rise to the application of such section.

(iii) *Leasehold of farm recapture property*. If property is farm recapture property under this subparagraph, a leasehold of such property is also farm recapture property is also farm recapture property to the same extent as described in, and in accordance with the principles of paragraph (a)(2) of § 1.1245–3.

(iv) If property described in subdivision (ii) of this subparagraph is stock or securities received in certain corporate transactions described in section 1251(d)(6), see paragraph (f) of § 1.1251–4 for determination as to extent such stock or securities is farm recapture property.

(2) *Examples*. The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example: On December 15, 1971, A, an individual calendar year taxpayer engaged in the trade or business of farming (as defined in paragraph (e) of this section) exchanges in a transaction which qualifies under section 1031(a) (relating to an exchange of property held for productive use or investment) tractor No. 1 which A acquired on March 1, 1971, for tractor No. 2. Under subparagraph (1)(i) of this paragraph, tractor No. 1 is farm recapture property as the tractor was used in the trade or business of farming and was held for a period in excess of 6 months. Under subparagraph (1)(ii) of this paragraph, tractor No. 2 is farm recapture property as the basis of tractor No. 2 in the hands of A is determined with reference to the adjusted basis of tractor No. 1.

(b) *Farm net loss*—(1) *In general*. The term *farm net loss* means the amount by which:

(i) The deductions allowed or allowable for the taxable year by chapter 1 of subtitle A of the Code which are directly connected with the carrying on of the trade or business of farming, exceed

(ii) The gross income derived from such trade or business.

(2) *Disposition of farm recapture property*. For purposes of subparagraph (1) of this paragraph, no gain or loss (regardless of how treated) resulting from the disposition of farm recapture property shall be taken into account, except that under subparagraph (1)(ii) of this paragraph gain upon disposition of such property which is recognized as ordinary income by reason of section 1245(a)(1) shall be taken into account. Thus, for example, if land used in the trade or business of farming were disposed of and gain of $3,000 was realized, then none of such gain would be taken into account in computing farm net loss and farm net income even if all or a portion of such gain is recognized as ordinary income by reason of section 1251(c)(1), section 1252(a)(1), or both. If such land were disposed of at a loss, the result would be the same. See paragraph (d)(1)(ii) of this section with respect to the exclusion of gain or loss from the disposition of farm recapture property from the computation of nonfarm adjusted gross income.

(3) *Amount of deduction under section 172(a) attributable to farm net loss*. (i) If all or a portion of a net operating loss (within the meaning of section 172(c)) for a taxable year is absorbed in another taxable year as a carryover or carry back, then for purposes of determining the amount of deductions referred to in subparagraph (1)(i) of this paragraph for such other taxable year the portion of the amount absorbed in such other taxable year which is attributable to amounts directly connected with the carrying on of the trade or business of farming shall be an amount equal to the amount absorbed, multiplied by a fraction the numerator of which is the amount of the farm net loss for the taxable year the net operating loss arose (but not in excess of the net operating loss for such year) and the denominator of which is the amount of the net operating loss for such year.

(ii) No portion of a farm net loss added to the excess deductions account in the year a net operating loss arose (or which would have been added to such account but for the application of the $25,000 or $12,500 farm net loss exclusion under paragraph (b) (2)(ii) or (4)(i)(*b*) of § 1.1251–2) shall be taken into account under subparagraph (1)(i) of this paragraph in any other taxable year. Accordingly the same farm net loss shall not be added to the excess deductions account more than once and a farm net loss for any taxable year shall not be subject to the $25,000 or $12,500 exclusion more than once.

(iii) If a net operating loss for a current taxable year attributable in whole or part to a farm net loss is carried back and absorbed in a preceding taxable year no redetermination shall be made with respect to (*a*) the amount of gain recognized as ordinary income under section 1251(c)(1) and paragraph (b) of § 1.1251–1 in any taxable year preceding the current taxable year, and (*b*) the amount of the taxpayer's excess deductions account allocated under paragraph (e)(2) of § 1.1251–2 to a donee as of the close of any taxable year preceding the current taxable year.

(4) *Special rules as to estates and trusts*. In the case of an estate or trust, computations of amounts under this paragraph shall be made without regard to

any deductions under section 651 or 661. If on the termination of an estate or trust the beneficiaries succeeding to its property are allowed a deduction under section 642(h) (relating to unused loss carryovers and excess deductions on termination available to beneficiaries), to the extent the carryover or excess deduction is attributable to a farm loss it shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amount of a carryover or of excess deductions from a particular taxable year of an estate or trust succeeded to under section 642(h) shall be allocated between amounts attributable to a farm net loss and other amounts in the same proportion as the farm net loss for such year bears to the amount of such carryover or of excess deductions. If there is more than one beneficiary, the total farm net loss succeeded to by all the beneficiaries shall be allocated to each beneficiary in proportion to the deduction of each under section 642(h).

(c) *Farm net income*. The term *farm net income* means the amount by which the amount referred to in paragraph (b)(1)(ii) of this section exceeds the amount referred to in paragraph (b)(1)(i) of this section.

(d) *Nonfarm adjusted gross income*—(1) *In general*. The term *nonfarm adjusted gross income* means adjusted gross income (taxable income in the case of a taxpayer other than an individual) computed without regard to:

(i) Income or deductions taken into account in computing farm net loss and farm net income,

(ii) Gains and losses (regardless of how treated) resulting from the disposition of farm recapture property, and

(iii) In the case of an estate or trust, the principles of paragraph (b)(4) of this section, to the extent applicable, shall apply.

(2) *Special rules*. The following rules in addition to the rules of subparagraph (1) of this paragraph, shall apply in computing the adjusted gross income of a shareholder of an electing small business corporation:

(i) The amount of any distribution described in section 1373 (c)(2) made by the corporation shall be disregarded,

(ii) For purposes of computing the amount includible in the gross income of a shareholder under section 1373(b), the corporation's undistributable taxable income shall equal the corporation's nonfarm adjusted gross income (as defined in subparagraph (1) of this paragraph) minus the amount described in section 1373(c)(1), and

(iii) For purposes of computing a shareholder's deduction under section 1374, the corporation's net operating loss shall be computed without regard to the items referred to in subparagraph (1) (i) and (ii) of this paragraph.

(e) *Trade or business of farming*—(1) *In general*. For purposes of section 1251, the term *trade or business of farming* includes any trade or business with respect to which the taxpayer may compute gross income under § 1.61–4, expenses under § 1.162–12, make an election under section 175, 180, or 182, or use an inventory method referred to in § 1.471–6. Such term does not include any activity not engaged in for profit within the meaning of section 183 and section 183–2.

(2) *Horse racing*. If a taxpayer is engaged in the raising of horses, including horses which are bred or purchased, then for purposes of section 1251 the term *trade or business of farming* also includes the racing of such horses by the taxpayer. Thus, for example, if a taxpayer purchases a yearling and develops it to the racing stage, the term *trade or business of farming* includes the racing of such horse.

(3) *Several businesses of farming*. If a taxpayer is engaged in more than one trade or business of farming, all such trades and businesses shall be treated as one trade or business.

[T.D. 7418, 41 FR 18826, May 7, 1976, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1251–4 Exceptions and limitations.

(a) *Exception for gifts*—(1) *General rule*. Section 1251(d)(1) provides that no gain shall be recognized under section 1251(c)(1) upon a disposition by gift. For purposes of this paragraph, the term *gift* shall have the same meaning as in paragraph (a) of § 1.1245–4 and, with respect to the application of this paragraph, principles illustrated by the examples of paragraph (a)(2) of § 1245–4 shall apply. For reduction in amount of

charitable contribution in case of a gift of farm recapture property, see section 170(e) and § 1.170A–4.

(2) *Disposition in part a sale or exchange and in part a gift.* Where a disposition of farm recpature property is in part a sale or exchange and in part a gift, the amount of gain recognized as ordinary income under section 1251(c)(1) shall not exceed:

(i) In the case of farm recapture property other than land, the excess of the amount realized over adjusted basis, and

(ii) In the case of land, the lower of the amount in subdivision (i) of this subparagraph or the potential gain (as defined in paragraph (b)(2)(ii) of § 1.1251–1.

(3) *Treatment of land in hand of transferee.* See paragraph (g) of this section for treatment of transferee in the case of a disposition of land to which this paragraph applies.

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

Example 1. A, a calendar year taxpayer, makes one disposition of farm recapture property during 1976. On March 2, 1976, A makes a gift to B (also a calendar year taxpayer) of a parcel of land which he had on January 15, 1971. On the date of such disposition, the excess of the fair market value ($65,000) over the adjusted basis of the land ($40,000) is $25,000 and the sum of the deductions allowable in respect of such land under sections 175 and 182 is $21,000 for 1971 and $3,000 (attributable to 1975) for the taxable year of disposition and the four immediately preceding taxable years. Thus, the potential gain (as defined in paragraph (b)(2)(ii) of § 1.1251–1) is limited to $3,000. At the end of 1976 (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A)), there is a balance in A's excess deductions account of $25,000. However, upon making the gift, A recognizes no gain under section 1251(c)(1) or section 1252(a)(1). See subparagraph (a)(1) of this paragraph and paragraph (a)(1) of § 1.1252–2. For treatment of the land in the hands of B, see example (1) of paragraph (g)(3) of this section. For effect of the gift on the excess deductions accounts of A and B, see paragraph (e)(2) of § 1.1251–2.

Example 2. Assume the same facts as in example (1), except that A transfers the land to B for $50,000. Thus, the gain realized is $10,000 (amount realized, $50,000, minus adjusted basis $40,000), and A has made a gift of $15,000 (fair market value, $65,000, minus amount realized, $50,000). Since under subparagraph (2)(ii) of this paragraph, the potential gain ($3,000) is lower than the gain realized ($10,000), the gain to which section 1251(c)(1) could apply is limited by subparagraph (2)(ii) of this paragraph to $3,000. Thus, as A has $25,000 in his excess deductions account, $3,000 is recognized as ordinary income under section 1251(c)(1). See example (2) of paragraph (a)(4) of § 1.1252–2 for computation of gain of $7,000 which is recognized as ordinary income by A under section 1252(a)(1). For treatment of the land in the hands of B, see example (2) of paragraph (g)(3) of this section.

(b) *Exception for transfers at death*—(1) *General rule.* Section 1251(d)(2) provides that, except as provided in section 691 (relating to income in respect of a decedent), no gain shall be recognized under section 1251(c)(1) upon a transfer at death. For purposes of this paragraph, the term *transfer at death* shall have the same meaning as in paragraph (b) of § 1.1245–4 and, with respect to the application of this paragraph, principles illustrated by the examples of paragraph (b)(2) of § 1.1245–4 shall apply.

(2) *Treatment of land in hands of transferee.* If as of the date a person acquires land which is farm recapture property from a decedent such person's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), then on such date the potential gain in respect to such land is zero.

(c) *Certain corporate transactions*—(1) *Limitation on amount of gain.* Under section 1251(d)(3), upon a transfer of property described in subparagraph (2) of this paragraph, the amount of gain recognized as ordinary income by the transferor under section 1251(c)(1) shall not exceed an amount equal to the excess (if any) of (i) the amount of gain recognized to the transferor on the transfer (determined without regard to section 1251) over (ii) the amount (if any) of gain recognized as ordinary income under section 1245(a)(1). For purposes of this subparagraph, the principles of paragraph (c)(1) of § 1.1245–4 shall apply. Thus, in case of a transfer of both farm recapture property and property other than farm recapture property in a single transaction, the amount realized from the disposition of

the farm recapture property (as determined in a manner consistent with the principles of paragraph (a)(5) of § 1.1245–1) shall be deemed to consist of that portion of the fair market value of each property acquired which bears the same ratio to the fair market value of such acquired property as the amount realized from the disposition of farm recapture property bears to the total amount realized. The preceding sentence shall be applied solely for purposes of computing the portion of the total gain (determined without regard to section 1251) which is eligible to be recognized as ordinary income under section 1251(c)(1). Section 1251(d)(3) does not apply to a disposition of property to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code.

(2) *Transfers covered.* The transfers referred to in subparagraphs (1) of this paragraph are transfers of farm recapture property in which the basis of such property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(i) Section 332 (relating to distributions in complete liquidation of an 80-percent-or-more controlled subsidiary corporation). For the application of section 1251(d)(3) to such a complete liquidation, the principles of paragraph (c)(3) of § 1.1245–4 shall apply. Thus, for example, the provisions of subparagraph (1) of this paragraph do not apply to a liquidating distribution of farm recapture property by an 80-percent-or-more controlled subsidiary to its parent if the parent's basis for the property is determined, under section 334(b)(2), by reference to its basis for the stock of the subsidiary.

(ii) Section 351 (relating to transfer to corporation controlled by transferor).

(iii) Section 351 (relating to exchanges pursuant to certain corporate reorganizations).

(iv) Section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings).

(v) Section 374(a) (relating to exchanges pursuant to certain railroad reorganizations).

(3) *Partnerships.* For the application of section 1251 to partnerships, see paragraph (e) of this section.

(4) *Treatment of land in hands of transferee.* See paragraph (g) of this section for treatment of transferee in the case of a disposition of land to which this paragraph applies.

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

Example 1. (i) A, an individual calendar year taxpayer, makes one disposition of farm recapture property during 1971. On January 20, 1971. A transfers farm recapture property (other than land and section 1245 property), having an adjusted basis of $22,000, to corporation M in exchange for stock in M worth $35,000 plus $15,000 in cash in a transaction qualifying under section 351. Thus, the amount realized is $50,000, and the gain realized is the excess of the amount realized, $50,000, over the adjusted basis, $22,000, or $28,000. Without regard to section 1251, A would recognize gain of $15,000 under section 351(b), and M's basis for the farm recapture property would be determined under section 362(a) by reference to its basis in the hands of A. Assume further that the balance in A's excess deductions account (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A)) at the close of 1971 is $20,000. Thus, since such balance in the excess deductions account ($20,000) is lower than the gain realized ($28,000), is subparagraph (1) of this paragraph did not apply, gain of $20,000 would be recognized as ordinary income under section 1251(c)(1). However, subparagraph (1) of this paragraph limits the amount of gain to be recognized as ordinary income under section 1251(c)(1) to $15,000.

(ii) If, however, A transferred the farm recapture property to M solely in exchange for stock worth $50,000, then, because of the application of subparagraph (1) of this paragraph he would not recognize any gain under section 1251(c)(1). If, instead, A transferred the farm recapture property to M in exchange for stock worth $25,000 and $25,000 cash, only $20,000 (the amount of such balance in the excess deductions account) of the gain of $25,000 recognized under section 351(b) would be recognized as ordinary income under section 1251(c)(1). The remaining $5,000 of gain recognized under section 351(b) may be treated as gain from the sale or exchange of property described in section 1231. In the hands of M, the property received from A is farm recapture property under the provisions of paragraph (a)(11)(ii) of § 1.1251–3. For treatment of the property received by A in such transaction; see section 1251(d)(6) and paragraph (f) of this section.

Example 2. Assume the same facts as in subdivision (i) of example (1), except that the farm recapture property is section 1245 property. Assume further than $5,000 is recognized as ordinary income under section 1245(a)(1), and that as of the close of 1971, A has a balance of $15,000 in his excess deductions account (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A) which, under paragraph (b) of § 1.1251–3, is computed by treating the $5,000 of gain to which section 1245 applies as gross income derived from the trade or business of farming). The amount of gain recognized as ordinary income under section 1251(c)(1) is $10,000, computed as follows:

(1) Amount of gain under section 1251(c)(1) (determined without regard to subparagraph (1) of this paragraph):.	
(a) Portion of gain realized ($28,000) in excess of amount recognized as ordinary income under section 1245(a)(1) ($5,000)	$23,000
(b) Excess deductions account balance	15,000
(c) Lower of (a) or (b)	15,000
(2) Limitation in subparagraph (1) of this paragraph:	
(a) Gain recognized (determined without regard to section 1251)	15,000
(b) Minus: Gain recognized as ordinary income under section 1245(a)(1)	5,000
(c) Difference	10,000
(3) Lower of line (1)(c) or line (2)(c)	10,000

(d) *Limitation for like kind exchanges and involuntary conversions*—(1) *General rule.* Under section 1251(d)(4), if farm recapture property is disposed of and gain (determined without regard to section 1251) is not recognized in whole or in part under section 1031 (relating to like kind exchanges) or section 1033 (relating to involuntary conversions), then the amount of gain recognized as ordinary income by the transferor under section 1251(c)(1) shall not exceed an amount equal to the excess (if any) of (i) the amount of gain recognized on such disposition (determined without regard to section 1251) or (ii) the amount (if any) of gain recognized as ordinary income under section 1245(a)(1).

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

Example 1. (i) A, an individual calendar year taxpayer, owns a herd of breeding cattle having an adjusted basis of $75,000 which he acquired on March 30, 1970, A receives insurance proceeds of $90,000. Thus, the gain realized is $15,000 (that is, the excess of the amount realized, $75,000), A makes no other disposition of farm recapture property during 1970. Assume that had the herd been sold at its fair market value on March 15, 1970, no gain would have been recognized as ordinary income under section 1245(a)(1). As of the close of 1970, A has a balance of $12,000 in his excess deductions account (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A)). Thus, since the balance in the excess deductions account, $12,000, is lower than the gain realized, $15,000, the amount of gain which would be recognized under section 1251(c)(1) (determined without regard to subparagraph (1) of this paragraph) would be $12,000.

(ii) Assume further that A spends $72,000 of the insurance proceeds to purchase another breeding herd, $10,000 to purchase stock in the acquisition of control of a corporation which owns property similar or related in service or use to the destroyed breeding herd, and retains cash of $8,000. Both of the acquisitions by A qualify under section 1033(a)(3)(A), and A properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain to $8,000 (that is, the amount by which the amount realized from the conversion, $90,000 exceeds the cost of the stock and other property acquired to replace the converted property, $72,000 plus $10,000). Thus, since $8,000 is the amount of gain which would be recognized under section 1033(a)(3) (determined without regard to section 1251), and since that amount is lower than the gain of $12,000 which would be recognized under section 1251(c)(1) (determined without regard to subparagraph (1) of this paragraph), under subparagraph (1) of this paragraph the amount of gain recognized under section 1251(c)(1) is limited to $8,000. The stock purchased for $10,000 qualifies under paragraph (a)(1)(ii)(*b*) of § 1.1251–3 as farm recapture property.

Example 2. (i) A, an individual calendar year taxpayer, owns land which he had acquired on March 7, 1970, having an adjusted basis of $48,000, and a fair market value of $67,500. On January 15, 1975, A, as a result of a condemnation action, receives $67,500 (its fair market value) for the land. The aggregate of the deductions allowable in respect of such land under sections 175 and 182 is $18,000, with $5,000 of such aggregate attributable to 1970 and $13,000 of such aggregate attributable to 1970 and $13,000 of such aggregate attributable to 1975 and the four preceding taxable years. Thus, the potential gain (as defined in paragraph (b)(2)(ii) of § 1.1251–1) is limited to $13,000, since that amount is lower than $19,500 (the excess of the fair market value of the land, $67,500, over its adjusted basis, $48,000). The gain realized by A is also $19,500. At the end of A's taxable year (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A)) there is a balance of

$21,000 in the excess deductions account of A. Since the potential gain, $13,000, is lower than both the excess deductions account balance, $21,000, and the gain realized, $19,500, A would recognize $13,000 as ordinary income under section 1251(c)(1) (determined without regard to subparagraph (1) of this paragraph).

(ii) Assume further that A spends the entire amount received, $67,500, to purchase stock in the acquisition of control of a corporation which owns property similar or related in service or use to A's condemned land which qualifies under section 1033(a)(3)(A), and A properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain to zero (that is, the amount by which the amount realized from the conversion, $67,500, exceeds the cost of the stock acquired to replace the converted land, $67,500). Thus, since no gain would be recognized under section 1033(a)(3) (determined without regard to section 1251), under subparagraph (1) of this paragraph, no gain is recognized under section 1251(c)(1). The stock purchased for $67,500 qualifies under paragraph (a)(1)(ii)(*b*) of §1.1251–3 as farm recapture property. See example (1) of paragraph (d)(2) of §1.1252–2 for a computation of gain recognized as ordinary income under section 1252(a)(1).

Example 3. B, an individual calendar year taxpayer, owns a herd of breeding cattle having an adjusted basis of $25,000 which he acquired on March 30, 1970. On March 15, 1976, the entire herd is destroyed by a blizzard and on March 20, 1976, B receives insurance proceeds of $90,000. Thus, the gain realized is $65,000 (that is, the excess of the amount realized, $90,000, over the adjusted basis, $25,000). B makes no other disposition of farm recapture property during 1976. B spends $60,000 of the insurance proceeds to purchase another breeding herd and retains cash of $30,000. The acquisition by B qualifies under section 1033(a)(3)(A), and B properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain to $30,000 (that is, the amount by which the amount realized from the conversion, $90,000, exceeds the cost of the property acquired to replace the converted property, $60,000). Assume that the amount of gain recognized under section 1245(a)(1) is $20,000, and that as of the close of 1976 B has a balance of $100,000 in his excess deductions account (after making the applicable additions and subtractions under section 1251(b) (2) and (3)(A) which, under paragraph (b) of §1.1251–3, is computed by treating the $20,000 of gain to which section 1245 applies as gross income derived from the trade or business of farming). The amount of gain recognized as ordinary income under section 1251(c)(1) is $10,000, computed as follows:

(1) Amount of gain under section 1251(c)(1) (determined without regard to subparagraph (1) of this paragraph):	
(a) Portion of gain realized ($65,000) in excess of amount recognized as ordinary income under section 1245(a)(1) ($20,000)	$45,000
(b) Excess deductions account balance	100,000
(c) Lower of (a) or (b)	45,000
(2) Limitation in subparagraph (1) of this paragraph:	
(a) Gain recognized (determined without regard to section 1251)	30,000
(b) Minus: Gain recognized as ordinary income under section 1245(a)(1)	$20,000
(c) Difference	10,000
(3) Lower of line (1)(c) or line (2)(c)	10,000

(3) *Application to single disposition of farm recapture property of one class and property of different class.* (i) If upon a sale of farm recapture property of one class gain would be recognized under section 1251(c)(1), and if such farm recapture property together with property of a different class or classes is disposed of in a single transaction in which gain is not recognized in whole or in part under section 1031 (without regard to section 1251(c)(1), then rules consistent with the principles of paragraph (d)(6) of §1.1250–3 (relating to gain from disposition of certain depreciable realty) shall apply for purposes of allocating the amount realized to each of the classes of property disposed of and for purposes of determining what property the amount realized for each class consists of.

(ii) For purposes of this subparagraph, the classes of property other than farm recapture property are (*a*) section 1245 property, (*b*) section 1250 property, and (*c*) other property.

(iii) For purposes of this subparagraph, the classes of farm recapture property are (*a*) hand, (*b*) farm recapture property other than land which is section 1245 property and (*c*) farm recapture property other than land which is not section 1245 property.

(4) *Treatment of land received in like kind exchange or involuntary conversion.* The aggregate of the deductions allowed under sections 175 and 182 in respect of land acquired in a transaction described in subparagraph (1) of this paragraph shall include the aggregate of the deductions allowable under sections 175 and 182 in respect of the land

transferred or converted (as the case may be) in such transaction minus the amount of gain taken into account under sections 1251(c) and 1252(a) with respect to the land transferred or converted. Upon a subsequent disposition of such land, such deductions shall be treated as having been allowable in the same taxable year as they were allowable with respect to the land transferred or converted.

(e) *Partnerships.* [Reserved]

(f) *Property transferred to controlled corporation.* [Reserved]

(g) *Treatment of land received by a transferee in a disposition by gift and certain tax-free transactions*—(1) *General rule.* If farm recapture property which is land is disposed of in a transaction which is either a gift to which paragraph (a)(1) of this section applies or a completely tax-free transfer to which section 1251(b)(5)(A) applies, then for purposes of section 1251:

(i) The aggregate of the deductions allowable under sections 175 and 182 in respect of the land in the hands of the transferee immediately after the disposition shall be an amount equal to the aggregate of such deductions for the taxable year and the four preceding taxable years in the hands of the transferor immediately before the disposition,

(ii) Upon a subsequent disposition by the transferee (including a computation of potential gain as defined in paragraph (b)(2)(ii) of §1.1251–1), such deductions in the hands of the transferee shall be treated as having been allowable with respect to the transferee in the same taxable year they were allowable to the transferor, and

(iii) If the taxable years of the transferor and transferee regularly end on different dates, then the aggregate of such deductions allowable for taxable year with respect to the transferor shall be treated in the hands of the transferee as allowable in the transferee's taxable year in which the taxable year of the transferor regularly ends.

(2) *Certain partially tax-free transfers.* If farm recapture property which is land is disposed of in a transaction which either is in part a sale or exchange and in part a gift to which paragraph (a)(2) of this section applies, or is a partially tax-free transfer to which section 1251(b)(5)(A) applies, then for purposes of section 1251:

(i) The amount determined under subparagraph (1)(i) of this paragraph shall be reduced by the amount of gain taken into account under sections 1251(c) and 1252(a) to the extent such gain is attributable to the sections 175 and 182 deductions for the taxable year and the preceding four taxable years (determined by attributing gain under section 1252(a) to the oldest years first) by the transferor upon the disposition, and

(ii) For purposes of subparagraph (1)(ii) of this paragraph, the amount of such gain recognized under sections 1251(c) and 1252(a) shall reduce the aggregate of deductions allowable under sections 175 and 182 for the taxable year and each of the preceding four taxable years on a pro rata basis.

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

Example 1. Assume the same facts as in example (1) of paragraph (a)(4) of this section. Therefore, on the date B receives the land in the gift transaction, under subparagraph (1)(i) and (ii) of this paragraph, the aggregate of the deductions allowable under sections 175 and 182 in respect of the land in the hands of B is the amount in the hands of A, $24,000, and for purposes of applying section 1251 upon a subsequent disposition by B (including the computation of potential gain) such deductions in the hands of B shall be treated as allowable in the same year as they were allowable to A. Thus, in respect to the land in the hands of B, the allowable section 175 and 182 deductions of $3,000 shall be treated as allowable in 1975.

Example 2. Assume the same facts as in example (2) of Paragraph (a)(4) of this section. Under paragraph (2) of this paragraph, the aggregate of the allowable sections 175 and 182 deductions with respect to the land which pass over to B for purposes of section 1251 is zero ($3,000 deduction allowable under sections 175 and 182 for the taxable year and the four preceding taxable years minus $3,000 gain taken into account by A in accordance with example (2) of paragraph (a)(4) of this section).

[T.D. 7818, 41 FR 18828, May 7, 1976; 41 FR 23669, June 11, 1976]

§ 1.1252–1 General rule for treatment of gain from disposition of farm land.

(a) *Ordinary income*—(1) *General rule.* (i) Except as otherwise provided in this section and § 1.1252–2, if farm land is disposed of during a taxable year beginning after December 31, 1969, then under section 1252(a)(1) there shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income) the lower of:

(*a*) The applicable percentage of the amount computed in subdivision (ii) of this subparagraph, or

(*b*) The amount computed in subdivision (iii) of this subparagraph.

(ii) The amount computed in this subdivision is an amount equal to:

(*a*) The aggregate of the deductions allowed, in any taxable year any day of which falls within the period the taxpayer held (or is considered to have held) the farm land, under sections 175 (relating to soil and water conservation expenditures) and 182 (relating to expenditures by farmers for clearing land) for expenditures paid or incurred after December 31, 1969, with respect to the farm land disposed of, minus

(*b*) The amount of gain recognized as ordinary income under section 1251(c)(1) (relating to gain from disposition of property used in farming where farm losses offset nonfarm income) upon such disposition of such land.

(iii) The amount computed in this subdivision is an amount equal to:

(*a*) The gain realized, that is, the excess of the amount realized (in the case of a sale, exchange, or involuntary conversion) or the fair market value of the farm land (in the case of any other disposition), over the adjusted basis of the farm land, minus

(*b*) The amount of gain recognized as ordinary income under section 1251(c)(1) upon such disposition of such land.

(iv) If a deduction under section 175 is allowed in respect of the farm land disposed of for a taxable year every day of which falls within the period after the taxpayer held (or is considered to have held) the farm land, and if the deduction is attributable to expenditures paid or incurred after December 31, 1969, with respect to such land during the period the taxpayer held (or is considered to have held) the land, then the amount of such deduction shall be applied to increase the amount computed (without regard to this subdivision) under subdivision (ii)(*a*) of this subparagraph.

(2) *Application of section.* Any gain treated as ordinary income under section 1252(a)(1) shall be recognized as ordinary income notwithstanding any other provision of subtitle A of the Code. For special rules with respect to the application of section 1252, see § 1.1252–2. For the relation of section 1252 to other provisions see paragraph (d) of this section.

(3) *Meaning of terms.* For purposes of section 1252:

(i) The term *farm land* means any land with respect to which deductions have been allowed under section 175 or 182. See section 1252(a)(2).

(ii) The period for which farm land shall be considered to be held shall be determined under section 1223.

(iii) The term *disposition* shall have the same meaning as in paragraph (a)(3) of § 1.1245–1.

(iv) The applicable percentage shall be determined as follows:

If the farm land is disposed of—	The applicable percentage is—
Within 5 years after the date it was acquired	100 percent.
Within the sixth year after it was acquired	80 percent.
Within the seventh year after it was acquired	60 percent.
Within the eighth year after it was acquired.	40 percent.
Within the ninth year after it was acquired.	20 percent.
Within the 10th year after it was acquired and thereafter.	0 percent.

(4) *Portion of parcel.* The amount of gain to be recognized as ordinary income under section 1252(a)(1) shall be determined separately for each parcel of farm land in a manner consistent with the principles of subparagraphs (4) and (5) of § 1.1245–1(a) (relating to gain from disposition of certain depreciable property). If (i) only a portion of a parcel of farm land is disposed of in a transaction, or if two or more portions of a single parcel are disposed of in one transaction, and (ii) the aggregate of the deductions allowed under sections 175 and 182 with respect to any such portion cannot be established to the satisfaction of the Commissioner or his delegate, then the aggregate of the deductions in respect of the entire parcel

shall be allocated to each portion in proportion to the fair market value of each at the time of the disposition.

(b) *Instances of non-application*—(1) *In general*. Section 1252 does not apply if a taxpayer disposes of farm land for which the holding period is in excess of 9 years or with respect to which no deductions have been allowed under sections 175 and 182.

(2) *Losses*. Section 1252(a)(1) does not apply to losses. Thus, section 1252(a)(1) does not apply if a loss is realized upon a sale, exchange, or involuntary conversion of property, all of which is farm land, nor does the section apply to a disposition of such property other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of such property is not greater than its adjusted basis.

(c) *Treatment of partnerships and partners*. [Reserved]

(d) *Relation of section 1252 to other provisions*—(1) *General*. The provisions of section 1252 apply notwithstanding any other provisions of subtitle A of the Code. Thus, unless an exception or limitation under §1.1252–2 applies, gain under section 1252(a)(1) is recognized notwithstanding any contrary nonrecognition provision or income characterizing provision. For example, since section 1252 overrides section 1231 (relating to property used in the trade or business), the gain recognized under section 1252(a)(1) upon a disposition of farm land will be treated as ordinary income and only the remaining gain, if any, from the disposition may be considered as gain from the sale or exchange of a capital asset if section 1231 is applicable. See example (1) of paragraph (e) of this section.

(2) *Nonrecognition sections overridden*. The nonrecognition of gain provisions of subtitle A of the Code which section 1252 overrides include, but are not limited to, sections 267(d), 311(a), 336, 337, and 512(b)(5). See §1.1252–2 for the extent to which section 1252(a)(1) overrides sections 332, 351, 361, 371(a), 374(a), 721, 731, 1031, and 1033.

(3) *Installment method*. Gain from a disposition to which section 1252(a)(1) applies may be reported under the installment method if such method is otherwise available under section 453 of the Code. In such case, the income (other than interest) on each installment payment shall (i) first be deemed to consist of gain to which section 1251(c)(1) applies (if applicable) until all such gain has been reported, (ii) the next portion (if any) of such income shall be deemed to consist of gain to which section 1252(a)(1) applies until all such gain has been reported, and (iii) finally the remaining portion (if any) of such income shall be deemed to consist of gain to which neither section 1251(c)(1) nor 1252(a)(1) applies. For treatment of amounts as interest on certain deferred payments, see section 483.

(4) *Exempt income*. With regard to exempt income, the principles of paragraph (e) of §1.1245–6 shall be applicable.

(5) *Treatment of gain not recognized under section 1252(a)(1)*. For treatment of gain not recognized under this section, the principles of paragraph (f) of §1.1245–6 shall be applicable.

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

Example 1. Individual A uses the calendar year as his taxable year. On April 10, 1975, he sells for $75,000 a parcel of farm land which he had acquired on January 5, 1970, with an adjusted basis of $52,500 for a realized gain of $22,500. The aggregate of the deductions allowed under sections 175 and 182 with respect to such land is $18,000 and all of such amount was allowed for 1970. Under the stated facts, none of the $22,500 gain realized is recognized as ordinary income under section 1251(c)(1) as there is no potential gain (as defined in section 1251(e)(5)) with respect to the farm land. Since no gain is recognized as ordinary income under section 1251(c)(1), and since the applicable percentage, 80 percent, of the aggregate of the deductions allowed under sections 175 and 182, $18,000, or $14,400, is lower than the gain realized, $22,500, the amount of gain recognized as ordinary income under section 1252(a)(1) is $14,400. The remaining $8,100 of the gain may be treated as gain from the sale or exchange of property described in section 1231.

Example 2. Assume the same facts as in example (2) of paragraph (b)(6) of §1.1251–1. Assume further that the aggregate of the amount of sections 175 and 182 deductions allowable to the M corporation is equal to the amount allowed. Under paragraph (a)(1) of the section, $5,000 is recognized as ordinary

income under section 1252(a)(1) upon the disposition of the land as a dividend, computed as follows:

(1) Aggregate of deductions allowed under sections 175 and 182	$18,000
(2) Minus: Gain recognized as ordinary income under section 1251(c)(1)	$13,000
(3) Difference	$5,000
(4) Multiply: Applicable percentage for property disposed of within the fifth year after it was acquired	100%
(5) Amount in paragraph (a)(1)(i)(*a*) of this section	$5,000
(6) Gain realized (fair market value $67,500, less adjusted basis, $45,000)	$22,500
(7) Minus: Amount in line (2)	$13,000
(8) Amount in paragraph (a)(1)(i)(b) of this section	$9,500
(9) Lower of line (5) or line (8)	$5,000

The *gain realized*, $22,500, minus the sum of the gain recognized as ordinary income under section 1251(c)(1), $13,000, and under section 1252(a)(1), $5,000, equals $4,500. Assuming section 311(d) (relating to certain distributions of appreciated property to redeem stock) does not apply, under section 311(a) the corporation does not recognize gain on account of the $4,500.

Example 3. Assume the same facts as in example (2) of this paragraph, except that M contracted to sell the land for $67,500 which would be paid in 10 equal payments of $6,750 each, plus a sufficient amount of interest so that section 483 does not apply. Assume further that the remaining gain of $4,500 is treated as gain from the sale or exchange of property described in section 1231. M properly elects under section 453 to report under the installment method gain of $13,000 to which section 1251(c)(1) applies, gain of $5,000 to which section 1252(a)(1) applies, and gain of $4,500 to which section 1231 applies. Since the total gain realized on the sale was $22,500, the gross profit realized on each installment payment is $2,250, i.e., $6,750 × ($67,500). Accordingly, the treatment of the income to be reported on each installment payment is as follows:

Payment No.	Applicable sections		
	1251	*1252*	*1231*
1	$2,250		
2	2,250		
3	2,250		
4	2,250		
5	2,250		
6	1,750	$500	
7		2,250	
8		2,250	
9			$2,250
10			2,250
Totals	13,000	5,000	4,500

[T.D. 7418, 41 FR 18831, May 7, 1976; 41 FR 23669, June 11, 1976]

§ 1.1252–2 Special rules.

(a) *Exception for gifts*—(1) *General rule.* In general, no gain shall be recognized under section 1252(a)(1) upon a disposition of farm land by gift. For purposes of section 1252 and this paragraph, the term *gift* shall have the same meaning as in paragraph (a) of § 1.1245–4 and, with respect to the application of this paragraph, principles illustrated by the examples of paragraph (a)(2) of § 1.1245–4 shall apply. For reduction in amount of charitable contribution in case of a gift of farm land, see section 170(e) and § 1.170A–4.

(2) *Disposition in part a sale or exchange and in part a gift.* Where a disposition of farm land is in part a sale or exchange and in part a gift, the amount of gain which shall be recognized as ordinary income under section 1252(a)(1) shall be computed under paragraph (a)(1) of § 1.1252–1, applied by treating the gain realized (for purposes of paragraph (a)(1)(iii)(*a*) of § 1.1252–1) as the excess of the amount realized over the adjusted basis of the farm land.

(3) *Treatment of farm land in hands of transferee.* See paragraph (f) of this section for treatment of the transferee in the case of a disposition to which this paragraph applies.

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

Example 1. On March 2, 1976, A, a calendar year taxpayer, makes a gift to B of a parcel of land having an adjusted basis of $40,000, a fair market value of $65,000, and a holding period of 6 years (A, having purchased the land on January 15, 1971). On the date of such gift, the aggregate of the deductions allowed to A under sections 175 and 182 with respect to the land is $24,000 with $21,000 of such amount attributable to 1971. Upon making the gift, A recognizes no gain under section 1251(c)(1) or section 1252(a)(1). See paragraph (a)(1) of § 1.1251–4 and subparagraph 1 of this paragraph. For treatment of the farm land in the hands of B, see example (1) of paragraph (f)(3) of this section. For effect of the gift on the excess deductions accounts of A and of B, see paragraph (e)(2) of § 1.1251–2.

Example 2. (i) Assume the same facts as in example (1), except that A transfers the land to B for $50,000. Thus, the gain realized is

$10,000 (amount realized, $50,000, minus adjusted basis, $40,000), and A has made a gift of $15,000 (fair market value, $65,000, minus amount realized, $50,000).

(ii) Upon the transfer of the land to B, A recognizes $3,000 of gain under section 1251(c)(1). See example (2) of paragraph (a)(4) of § 1.1251–4. Thus, A recognizes $7,000 as ordinary income under section 1252(a)(1), computed under subparagraph (2) of this paragraph as follows:

(1) Aggregate of deductions allowed under sections 175 and 182	$24,000
(2) Minus: Gain recognized as ordinary income under section 1251(c)(1)	$3,000
(3) Difference	$21,000
(4) Multiply: Applicable percentage for land disposed of within sixth year after it was acquired	80%
(5) Amount in paragraph (a)(1)(i)(*a*) of § 1.1252–1	$16,800
(6) Gain realized (see subdivision (i) of this example)	$10,000
(7) Minus: Amount in line (2)	$3,000
(8) Amount in paragraph (a)(1)(i)(*b*) of § 1.1252–1, applied in accordance with subparagraph (2) of this paragraph	$7,000
(9) Lower of line (5) or line (8)	$7,000

Thus, the entire gain realized on the transfer, $10,000, is recognized as ordinary income since that amount is equal to the sum of the gain recognized as ordinary income under section 1251(c)(1), $3,000, and under section 1252(a)(1), $7,000. For treatment of the farm land in the hands of B, see example (2) of paragraph (f)(3) of this section.

(b) *Exception for transfers at death*—(1) *In general*. Except as provided in section 691 (relating to income in respect of a decedent), no gain shall be recognized under section 1252(a)(1) upon a transfer at death. For purposes of section 1252 and this paragraph, the term *transfer at death* shall have the same meaning as in paragraph (b) of § 1.1245–4 and, with respect to the application of this paragraph, principles illustrated by the examples of paragraph (b)(2) of § 1.1245–4 shall apply.

(2) *Treatment of farm land in hands of transferee*. If as of the date a person acquires farm land from a decedent such person's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternative valuation date), then on such date the aggregate of the sections 175 and 182 deductions allowed with respect to the farm land in the hands of such transferee is zero.

(c) *Limitation for certain tax-free transactions*—(1) *Limitation on amount of gain*. Upon a transfer of farm land described in subparagraph (2) of this paragraph, the amount of gain recognized as ordinary income under section 1252(a)(1) shall not exceed an amount equal to the excess (if any) of (i) the amount of gain recognized to the transferor on the transfer (determined without regard to section 1252) over (ii) the amount (if any) of gain recognized as ordinary income under section 1251(c)(1). For purposes of this subparagraph, the principles of paragraph (c)(1) of § 1.1245–4 shall apply. Thus, in the case of a transfer of farm land and property other than farm land in one transaction, the amount realized from the disposition of the farm land (as determined in a manner consistent with the principles of paragraph (a)(5) of § 1.1245–1) shall be deemed to consist of that portion of the fair market value of each property acquired which bears the same ratio to the fair market value of such acquired property as the amount realized from the disposition of the farm land bears to the total amount realized. The preceding sentence shall be applied solely for purposes of computing the portion of the total gain (determined without regard to section 1252) which is eligible to be recognized as ordinary income under section 1252(a)(1). The provisions of this paragraph do not apply to a disposition of property to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by Chapter 1 of the Code.

(2) *Transfers covered*. The transfers referred to in subparagraph (1) of this paragraph are transfers of farm land in which the basis of such property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(i) Section 332 (relating to distributions in complete liquidation of an 80-percent-or-more controlled subsidiary corporation). For application of subparagraph (1) of this paragraph to such a complete liquidation, the principles of paragraph (c)(3) of § 1.1245–4 shall

apply. Thus, for example, the provisions of subparagraph (1) of this paragraph do not apply to a liquidating distribution of farm land by an 80-percent-or-more controlled subsidiary to its parent if the parent's basis for the property is determined, under section 334(b)(2), by reference to its basis for the stock of the subsidiary.

(ii) Section 351 (relating to transfer to a corporation controlled by transferor).

(iii) Section 361 (relating to exchanges pursuant to certain corporate reorganizations).

(iv) Section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings).

(v) Section 374(a) (relating to exchanges pursuant to certain railroad reorganizations).

(vi) Section 721 (relating to transfers to a partnership in exchange for a partnership interest). See paragraph (e) of this section.

(vii) Section 731 (relating to distributions by a partnership to a partner). For special carryover of basis rule, see paragraph (e) of this section.

(3) *Treatment of farm land in the hands of tranferee.* See paragraph (f) of this section for treatment of the transferee in the case of a disposition to which this paragraph applies.

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

Example 1. On January 4, 1975, A, an individual calendar year taxpayer, owns a parcel of farm land, which he acquired on March 25, 1970, having an adjusted basis of $15,000 and a fair market value of $40,000. On that date he transfers the parcel to corporation M in exchange for stock in the corporation worth $40,000 in a transaction qualifying under section 351. On the date of such transfer, the aggregate of the deductions allowed under sections 175 and 182 with respect to the land is $18,000. Without regard to section 1252, A would recognize no gain under section 351 upon the transfer and M's basis for the land would be determined under section 362(a) by reference to its basis in the hands of A. Thus, as a result of the disposition, no gain is recognized as ordinary income under section 1251(c)(1) or section 1252(a)(1) by A since the amount of gain recognized under such sections is limited to the amount of gain which is recognized under section 351 (determined without regard to sections 1251 and 1252). See paragraph (c)(1) of § 1.1251–4 and subparagraph (1) of this paragraph. For treatment of the farm land in the hands of B, see paragraph (f)(1) of this section. For effect of the transfer on the excess deductions account of A and of B, see paragraph (e)(1) of § 1.1251–2.

Example 2. Assume the same facts in example (1), except that A transferred the land to M for stock in the corporation worth $32,000 and $8,000 cash. The gain realized is $25,000 (amount realized, $40,000, minus adjusted basis, $15,000). Without regard to section 1252, A would recognize $8,000 of gain under section 351(b). Assume further that no gain is recognized as ordinary income under section 1251(c)(1). Therefore, since the applicable percentage, 100 percent, of the aggregate of the deductions allowed under sections 175 and 182, $18,000, is lower than the gain realized, $25,000, the amount of gain to be recognized as ordinary income under section 1252(a)(1) would be $18,000 if the provisions of subparagraph (1) of this paragraph do not apply. Since under section 351(b) gain in the amount of $8,000 would be recognized to the transferor without regard to section 1252, the limitation provided in subparagraph (1) of this paragraph limits the gain taken into account by A under section 1252(a)(1) to $8,000.

Example 3. Assume the same facts as in example (2), except that $5,000 of gain is recognized as ordinary income under section 1251(c)(1). The amount of gain recognized as ordinary income under section 1252(a)(1) is $3,000 computed as follows:

(1) Amount of gain under section 1252(a)(1) (determined without regard to subparagraph (1) of this paragraph):	
(a) Aggregate of deductions allowed under sections 175 and 182	$18,000
(b) Minus: Gain recognized as ordinary income under section 1251(c)(1)	$5,000
(c) Difference	$13,000
(d) Multiply: Applicable percentage for property disposed of within the fifth year after it was acquired	100%
(e) Amount in paragraph (a)(1)(i)(*a*) of § 1.1252–1	$13,000
(f) Gain realized (amount realized $40,000, less adjusted basis, $15,000)	$25,000
(g) Minus: Amount in line (b)	$5,000
(h) Amount in paragraph (a)(1)(i)(*b*) of § 1.1252–1	$20,000
(i) Lower of line (e) or (h)	$13,000
(2) Limitation in subparagraph (1) of this paragraph:	
(a) Gain recognized (determined without regard to section 1252)	$8,000
(b) Minus: Gain recognized as ordinary income under section 1251(c)(1)	$5,000
(c) Difference	$3,000
(3) Lower of line (1)(i) or line (2)(c)	$3,000

Thus, the entire gain recognized under section 351(b) (determined without regard to sections 1251 and 1252), $8,000, is recognized as

ordinary income since that amount is equal to the sum of the gain recognized as ordinary income under section 1251(c)(1), $5,000, and under section 1252(a)(1), $3,000.

(d) *Limitation for like kind exchanges and involuntary conversions*—(1) *General rule*. If farm land is disposed of and gain (determined without regard to section 1252) is not recognized in whole or in part under section 1031 (relating to like kind exchanges) or section 1033 (relating to involuntary conversions), then the amount of gain recognized as ordinary income by the transferor under section 1252(a)(1) shall not exceed the sum of:

(i) The excess (if any) of (*a*) the amount of gain recognized on such disposition (determined without regard to section 1252) over (*b*) the amount (if any) of gain recognized as ordinary income under section 1251(c)(1), plus

(ii) The fair market value of property acquired which is not farm land and which is not taken into account under subdivision (i) of this subparagraph (that is, the fair market value of property other than farm land acquired which is qualifying property under section 1031 or 1033, as the case may be).

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

Example 1. (i) Assume the same facts as in example (2)(ii) of paragraph (d)(3) of § 1.1251–4. Assume further that the aggregate of the amount of sections 175 and 182 deductions allowable is equal to the amount allowed. Under paragraph (a)(1) of § 1.1252–1, $18,000 would be recognized as ordinary income under section 1252(a)(1) (determined without regard to subparagraph (1) of this paragraph), computed as follows:

(1) Aggregate of deductions allowed under sections 175 and 182	$18,000
(2) Minus: Gain recognized as ordinary income under section 1251(c)(1)	0
(3) Difference	$18,000
(4) Multiply: Applicable percentage for property disposed of within the fifth year after it was acquired	100%
(5) Amount in paragraph (a)(1)(i)(*a*) of § 1.1252–1	$18,000
(6) Gain realized (amount realized, $67,500, less adjusted basis, $48,000)	$19,500
(7) Minus: Amount in line (2)	0
(8) Amount in paragraph (a)(1)(i)(*b*) of § 1.1252–1	$19,500
(9) Lower of line (5) or line (8)	$18,000

(ii) Although no gain was recognized under section 1251(c)(1) and the stock purchased by A for $67,500 is farm recapture property for purposes of section 1251, it is not farm land for purposes of section 1252. Nevertheless, although no gain would be recognized under sections 1033(a)(3) and 1251(c)(1) (determined without regard to section 1252), the limitation under subparagraph (1) of this paragraph is $67,500 (that is, the fair market value of property other than farm land acquired which is qualifying property under section 1033). Since the amount of gain which would be recognized as ordinary income under section 1252(a)(1) (determined without regard to subparagraph (1) of this paragraph), $18,000 (as computed in subdivision (i) of this example), is lower than the amount of such limitation, $67,500, accordingly, only $18,000 is recognized as ordinary income under section 1252(a)(1). For determination of basis of the stock acquired, see subparagraph (5) of this paragraph.

Example 2. (i) Assume the same facts as in example (1) of this subparagraph, except that the cost of the stock was $62,500 (its fair market value). Thus, the amount of gain recognized on the disposition under section 1033(a)(3) (determined without regard to sections 1251 and 1252) is $5,000, that is, $67,500 minus $62,500. Assume further that $5,000 (the amount of gain recognized under section 1033(a)(3) (so determined)) was recognized as ordinary income under section 1251(c)(1). The amount of gain recognized as ordinary income under section 1252(a)(1) is $13,000, computed as follows:

(1) Amount of gain under section 1252(a)(1) (determined without regard to subparagraph (1) of this paragraph):	
(a) Aggregate of deductions allowed under sections 175 and 182	$18,000
(b) Minus: Gain recognized as ordinary income under section 1251(c)(1)	$5,000
(c) Difference	$13,000
(d) Multiply: Applicable percentage for property disposed of within the fifth year after it was acquired	100%
(e) Amount in paragraph (a)(1)(i)(*a*) of § 1.1252–1	$13,000
(f) Gain realized (amount realized, $67,500 (less adjusted basis, $48,000))	$19,500
(g) Minus: Amount in line (b)	$5,000
(h) Amount in paragraph (a)(1)(i)(*b*) of § 1.1252–1	$14,500
(i) Lower of line (e) or (h)	$13,000
(2) Limitation in subparagraph (1) of this paragraph:	
(a) Gain recognized (determined without regard to section 1252)	$5,000
(b) Minus: Gain recognized as ordinary income under section 1251(c)(1)	$5,000
(c) Difference	0

(d) Plus; The fair market value of property other than farm land acquired which is qualifying property under section 1033	$62,500
(e) Sum of lines (c) and (d)	$62,500
(3) Lower of line (1)(i) or line (2)(e)	$13,000

(3) *Application to single disposition of farm land and property of different class.* (i) If upon a sale of farm land gain would be recognized under section 1252(a)(1), and if such land together with property of a different class or classes is disposed of in one transaction in which gain is not recognized in whole or in part under section 1031 or 1033 (without regard to section 1252(a)(1)), then rules consistent with the principles of paragraph (d)(6) of §1.1250–3 (relating to gain from disposition of certain depreciable realty) shall apply for purposes of allocating the amount realized to each of the classes of property disposed of and for purposes of determining what property the amount realized for each class consists of.

(ii) For purposes of this subparagraph, the classes of property other than farm recapture property (as defined in section 1251(e) and paragraph (a)(1) of §1.1251–3) are (*a*) section 1245 property, (*b*) section 1250 property, and (*c*) other property.

(iii) For purposes of this subparagraph, the classes of farm recapture property are (*a*) land, (*b*) section 1245 property, and (*c*) other property.

(4) *Treatment of farm land received in like kind exchange or involuntary conversion.* The aggregate of the deductions allowed under sections 175 and 182 in respect of land acquired in a transaction described in subparagraph (1) of this paragraph shall include the aggregate of the deductions allowed under sections 175 and 182 in respect of the land transferred or converted (as the cr sections 175 and 182 in respect of land acquired in a transaction described in subparagraph (1) of this paragraph shall include the aggregate of the deductions allowed under sections 175 and 182 in respect of the land transferred or converted (as the case may be) in such transaction minus the amount of gain taken into account under sections 1251(c) and 1252(a) with respect to the land transferred or converted. Upon a subsequent disposition of such land, the holding period shall include the holding period with respect to the land transferred or converted.

(5) *Basis adjustment.* In order to reflect gain recognized under section 1252(a)(1) if property is acquired in a transaction to which subparagraph (1) of this paragraph applies, its basis shall be determined under the rules of section 1031(d) or 1033(c).

(e) *Partnerships.* [Reserved]

(f) *Treatment of farm land received by a transferee in a disposition by gift and certain tax-free transactions*—(1) *General rule.* If farm land is disposed of in a transaction which is either a gift to which paragraph (a)(1) of this section applies, or a completely tax-free transfer to which paragraph (c)(1) of this section applies, then for purposes of section 1252:

(i) The aggregate of the deductions allowed under sections 175 and 182 in respect of the land in the hands of the tranferee immediately after the disposition shall be an amount equal to the amount of such aggregate in the hands of the transferor immediately before the disposition, and

(ii) For purposes of applying section 1252 upon a subsequent disposition by the transferee (including a computation of the applicable percentage), the holding period of the transferee shall include the holding period of the transferor.

(2) *Certain partially tax-free transfers.* If farm land is disposed of in a transaction which either is in part a sale or exchange and in part a gift to which paragraph (a)(2)of this section applies, or is a partially tax-free transfer to which paragraph (c)(1) of this section applies, then for purposes of section 1252 the amount determined under subparagraph (1)(i) of this paragraph shallbe reduced by the amount of gain taken into account under sections 1251(c) and 1252(a) by the transferor upon the disposition. Upon a subsequent disposition by the transferee, the holding period for purposes of computing the amount under section 1252(a)(1)(A), with respect to the 175 and 182 deductions taken by the transferor, shall include the holding period of the transferor. With respect to the 1975 and 182 deductions taken by the

transferee, the holding period shall not include the holding period of the transferor.

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

Example 1. Assume the same facts as in example (1) of paragraph (a)(4) of this section. Therefore, on the date B receives the farm land in the gift transaction, under subparagraph (1) of this paragraph the aggregate of the deductions allowed under sections 175 and 182 in respect of the farm land in the hands of B is the amount in the hands of A, $24,000, and for purposes of applying section 1252 upon a subsequent disposition by B (including a computation of the applicable percentage) the holding period of B includes the holding period of A.

Example 2. Assume the same facts as in example (2) of paragraph (a)(4) of this section. Under subparagraph (2) of this paragraph, the aggregate of the sections 175 and 182 deductions which pass over to B for purposes of section 1252 is $14,000 ($24,000 deductions allowable under sections 175 and 182 minus $3,000 gain recognized under section 1251(c) in accordance with example (2) of paragraph (a)(4) of §1.1251–4, minus $7,000 gain recognized under section 1252(a) in acordance with example (2) of paragraph (a)(4) of this section), B's holding period includes the holding period of A (i.e., the period back to January 15, 1971) with respect to A's deductions.

(g) *Disposition of farm land not specifically covered*. If farm land is disposed of in a transaction not specifically covered under §1.1252–1 and this section, then the principles of section 1245 shall apply.

[T.D. 7418, 41 FR 18832, May 7, 1976; 41 FR 23669, June 11, 1976]

§ 1.1254–0 Table of contents for section 1254 recapture rules.

This section lists the major captions contained in §§1.1254–1 through 1.1254–6.

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(2) Disposition of an undivided interest.
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(d) Property distributed to a partner.
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§ 1.1254–6 Effective date of regulations.

[T.D. 8586, 60 FR 2501, Jan. 10, 1995, as amended by T.D. 8684, 61 FR 53063, Oct. 10, 1996]

§ 1.1254–1 Treatment of gain from disposition of natural resource recapture property.

(a) *In general.* Upon any disposition of section 1254 property or any disposition after December 31, 1975 of oil, gas, or geothermal property, gain is treated as ordinary income in an amount equal to the lesser of the amount of the section 1254 costs (as defined in paragraph (b)(1) of this section) with respect to the property, or the amount, if any, by which the amount realized on the sale, exchange, or involuntary conversion, or the fair market value of the property on any other disposition, exceeds the adjusted basis of the property. However, any amount treated as ordinary income under the preceding sentence is not included in the taxpayer's *gross income from the property* for purposes of section 613. Generally, the lesser of the amounts described in this paragraph (a) is treated as ordinary income even though, in the absence of section 1254(a), no gain would be recognized upon the disposition under any other provision of the Internal Revenue Code. For the definition of the term *section 1254 costs*, see paragraph (b)(1) of this section. For the definition of the terms *section 1254 property, oil, gas, or geothermal property*, and *natural resource recapture property*, see paragraph (b)(2) of this section. For rules relating to the *disposition* of natural resource recapture property, see paragraphs (b)(3), (c), and (d) of this section. For exceptions and limitations to the application of section 1254(a), see § 1.1254–2.

(b) *Definitions*—(1) *Section 1254 costs*—(i) *Property placed in service after December 31, 1986.* With respect to any property placed in service by the taxpayer after December 31, 1986, the term *section 1254 costs* means—

(A) The aggregate amount of expenditures that have been deducted by the taxpayer or any person under section 263, 616, or 617 with respect to such property and that, but for the deduction, would have been included in the adjusted basis of the property or in the adjusted basis of certain depreciable property associated with the property; and

(B) The deductions for depletion under section 611 that reduced the adjusted basis of the property.

(ii) *Property placed in service before January 1, 1987.* With respect to any property placed in service by the taxpayer before January 1, 1987, the term *section 1254 costs* means—

(A) The aggregate amount of costs paid or incurred after December 31, 1975, with respect to such property, that have been deducted as intangible drilling and development costs under section 263(c) by the taxpayer or any other person (except that section 1254 costs do not include costs incurred

with respect to geothermal wells commenced before October 1, 1978) and that, but for the deduction, would be reflected in the adjusted basis of the property or in the adjusted basis of certain depreciable property associated with the property; reduced by

(B) The amount (if any) by which the deduction for depletion allowed under section 611 that was computed either under section 612 or sections 613 and 613A, with respect to the property, would have been increased if the costs (paid or incurred after December 31, 1975) had been charged to capital account rather than deducted.

(iii) *Deductions under section 59 and section 291.* Amounts capitalized pursuant to an election under section 59(e) or pursuant to section 291(b) are treated as section 1254 costs in the year in which an amortization deduction is claimed under section 59(e)(1) or section 291(b)(2).

(iv) *Suspended deductions.* If a deduction of a section 1254 cost has been suspended as of the date of disposition of section 1254 property, the deduction is not treated as a section 1254 cost if it is included in basis for determining gain or loss on the disposition. On the other hand, if the deduction will eventually be claimed, it is a section 1254 cost as of the date of disposition. For example, a deduction suspended pursuant to the 65 percent of taxable income limitation of section 613A(d)(1) may either be included in basis upon disposition of the property or may be deducted in a year after the year of disposition. See §1.613A–4(a)(1). If it is included in the basis then it is not a section 1254 cost, but if it is deductible in a later year it is a section 1254 cost as of the date of the disposition.

(v) *Previously recaptured amounts.* If an amount has been previously treated as ordinary income pursuant to section 1254, it is not a section 1254 cost.

(vi) *Nonproductive wells.* The aggregate amount of section 1254 costs paid or incurred on any property includes the amount of intangible drilling and development costs incurred on nonproductive wells, but only to the extent that the taxpayer recognizes income on the foreclosure of a nonrecourse debt the proceeds from which were used to finance the section 1254 costs with respect to the property. For this purpose, the term nonproductive well means a well that does not produce oil or gas in commercial quantities, including a well that is drilled for the purpose of ascertaining the existence, location, or extent of an oil or gas reservoir (e.g., a delineation well). The term *nonproductive well* does not include an injection well (other than an injection well drilled as part of a project that does not result in production in commercial quantities).

(vii) *Calculation of amount described in paragraph (b)(1)(ii)(B) of this section (hypothetical depletion offset)*—(A) *In general.* In calculating the amount described in paragraph (b)(1)(ii)(B) of this section, the taxpayer shall apply the following rules. The taxpayer may use the 65-percent-of-taxable-income limitation of section 613A(d)(1). If the taxpayer uses that limitation, the taxpayer is not required to recalculate the effect of such limitation with respect to any property not disposed of. That is, the taxpayer may assume that the hypothetical capitalization of intangible drilling and development costs with respect to any property disposed of does not affect the allowable depletion with respect to property retained by the taxpayer. Any intangible drilling and development costs that, if they had not been treated as expenses under section 263(c), would have properly been capitalized under §1.612–4(b)(2) (relating to items recoverable through depreciation under section 167 or cost recovery under section 168) are treated as costs described in §1.612–4(b)(1) (relating to items recoverable through depletion). The increase in depletion attributable to the capitalization of intangible drilling and development costs is computed by subtracting the amount of cost or percentage depletion actually claimed from the amount of cost or percentage depletion that would have been allowable if intangible drilling and development costs had been capitalized. If the remainder is zero or less than zero, the entire amount of intangible drilling and development costs attributable to the property is recapturable.

(B) *Example.* The following example illustrates the principles of paragraph (b)(1)(vii)(A).

Example: Hypothetical depletion offset. In 1976, A purchased undeveloped property for $10,000. During 1977, A incurred $200,000 of productive well intangible drilling and development costs with respect to the property. A deducted the intangible drilling and development costs as expenses under section 263(c). Estimated reserves of 150,000 barrels of recoverable oil were discovered in 1977 and production began in 1978. In 1978, A produced and sold 30,000 barrels of oil at $8 per barrel, resulting in $240,000 of gross income. A had no other oil or gas production in 1978. A claimed a percentage depletion deduction of $52,800 (i.e., 22% of $240,000 gross income from the property). If A had capitalized the intangible drilling and development costs, assume that $200,000 of the costs would have been allocated to the depletable property and none to depreciable property. A's cost depletion deduction if the intangible drilling and development costs had been capitalized would have been $42,000 (i.e., (($200,000 intangible drilling and development costs + $10,000 acquisition costs) × 30,000 barrels of production)/ 150,000 barrels of estimated recoverable reserves). Since this amount is less than A's depletion deduction of $52,800 (percentage depletion), no reduction is made to the amount of intangible drilling and development costs ($200,000). On January 1, 1979, A sold the oil property to B for $360,000 and calculated section 1254 recapture without reference to the 65-percent-of-taxable-income limitation. A's gain on the sale is the entire $360,000, because A's basis in the property at the beginning of 1979 is zero (i.e., $10,000 cost less $52,800 depletion deduction for 1978). Since the section 1254 costs ($200,000) are less than A's gain on the sale, $200,000 is treated as ordinary income under section 1254(a). The remaining amount of A's gain ($160,000) is not subject to section 1254(a).

(2) *Natural resource recapture property*—(i) *In general.* The term *natural resource recapture property* means section 1254 property or oil, gas, or geothermal property as those terms are defined in this section.

(ii) *Section 1254 property.* The term *section 1254 property* means any property (within the meaning of section 614) that is placed in service by the taxpayer after December 31, 1986, if any expenditures described in paragraph (b)(1)(i)(A) of this section (relating to costs under section 263, 616, or 617) are properly chargeable to such property, or if the adjusted basis of such property includes adjustments for deductions for depletion under section 611.

(iii) *Oil, gas, or geothermal property.* The term *oil, gas, or geothermal property* means any property (within the meaning of section 614) that was placed in service by the taxpayer before January 1, 1987, if any expenditures described in paragraph (b)(1)(ii)(A) of this section are properly chargeable to such property.

(iv) *Property to which section 1254 costs are properly chargeable.* (A) An expenditure is properly chargeable to property if—

(*1*) The property is an operating mineral interest with respect to which the expenditure has been deducted;

(*2*) The property is a nonoperating mineral interest (e.g., a net profits interest or an overriding royalty interest) burdening an operating mineral interest if the nonoperating mineral interest is carved out of an operating mineral interest described in paragraph (b)(2)(iv)(A)(*1*) of this section;

(*3*) The property is a nonoperating mineral interest retained by a lessor or sublessor if such lessor or sublessor held, prior to the lease or sublease, an operating mineral interest described in paragraph (b)(2)(iv)(A)(*1*) of this section; or

(*4*) The property is an operating or a nonoperating mineral interest held by a taxpayer if a party related to the taxpayer (within the meaning of section 267(b) or section 707(b)) held an operating mineral interest (described in paragraph (b)(2)(iv)(A)(*1*) of this section) in the same tract or parcel of land that terminated (in whole or in part) without being disposed of (e.g., a working interest which terminated after a specified period of time or a given amount of production), but only if there exists between the related parties an arrangement or plan to avoid recapture under section 1254. In such a case, the taxpayer's section 1254 costs with respect to the property include those of the related party.

(B) *Example.* The following example illustrates the provisions of paragraph (2)(iv)(A)(*4*) of this section:

Example: Arrangement or plan to avoid recapture. C, an individual, owns 100% of the stock of both X Co. and Y Co. On January 1, 1998, X Co. enters into a standard oil and gas lease. X Co. immediately assigns to Y Co. 1% of the working interest for one year, and 99% of the working interest thereafter. In 1998, X Co. and Y Co. expend $300 in intangible drilling and development costs developing the tract, of which $297 are deducted by X Co.

under section 263(c). On January 1, 1999, Y Co. sells its 99% share of the working interest to an unrelated person. Based on all the facts and circumstances, the arrangement between X Co. and Y Co. is part of a plan or arrangement to avoid recapture under section 1254. Therefore, Y Co. must include in its section 1254 costs the $297 of intangible drilling and development costs deducted by X Co.

(v) *Property the basis of which includes adjustments for depletion deductions.* The adjusted basis of property includes adjustments for depletion under section 611 if—

(A) The basis of the property has been reduced by reason of depletion deductions; or

(B) The property has been carved out of or is a portion of property the basis of which has been reduced by reason of depletion deductions.

(vi) *Property held by a transferee.* Property held by a transferee is natural resource recapture property if the property was natural resource recapture property in the hands of the transferor and the transferee's basis in the property is determined with reference to the transferor's basis in the property (e.g., a gift) or is determined under section 732.

(vii) *Property held by a transferor.* Property held by a transferor of natural resource recapture property is natural resource recapture property if the transferor's basis in the property received is determined with reference to the transferor's basis in the property transferred by the transferor (e.g., a like kind exchange). For purposes of this paragraph (b)(2), property described in this paragraph (b)(2)(vii) is treated as placed in service at the time the property transferred by the transferor was placed in service by the transferor.

(3) *Disposition*—(i) *General rule.* The term *disposition* has the same meaning as in section 1245, relating to gain from dispositions of certain depreciable property.

(ii) *Exceptions.* The term *disposition* does not include—

(A) Any transaction that is merely a financing device, such as a mortgage or a production payment that is treated as a loan under section 636 and the regulations thereunder;

(B) Any abandonment (except that an abandonment is a disposition to the extent the taxpayer recognizes income on the foreclosure of a nonrecourse debt);

(C) Any creation of a lease or sublease of natural resource recapture property;

(D) Any termination or election of the status of an S corporation;

(E) Any unitization or pooling arrangement;

(F) Any expiration or reversion of an operating mineral interest that expires or reverts by its own terms, in whole or in part; or

(G) Any conversion of an overriding royalty interest that, at the option of the grantor or successor in interest, converts to an operating mineral interest after a certain amount of production.

(iii) *Special rule for carrying arrangements.* In a carrying arrangement, liability for section 1254 costs attributable to the entire operating mineral interest held by the carrying party prior to reversion or conversion remains attributable to the reduced operating mineral interest retained by the carrying party after a portion of the operating mineral interest has reverted to the carried party or after the conversion of an overriding royalty interest that, at the option of the grantor or successor in interest, converts to an operating mineral interest after a certain amount of production.

(c) *Disposition of a portion of natural resource recapture property*—(1) *Disposition of a portion (other than an undivided interest) of natural resource recapture property*—(i) *Natural resource recapture property subject to the general rules of § 1.1254–1.* For purposes of section 1254(a)(1) and paragraph (a) of this section, except as provided in paragraphs (c) (1)(ii) and (3) of this section, in the case of the disposition of a portion (that is not an undivided interest) of natural resource recapture property, the entire amount of the section 1254 costs with respect to the natural resource recapture property is treated as allocable to that portion of the property to the extent of the amount of gain to which section 1254(a)(1) applies. If the amount of the gain to which section 1254(a)(1) applies is less than the amount of the section 1254 costs with

respect to the natural resource recapture property, the balance of the section 1254 costs remaining after allocation to the portion of the property that was disposed of remains subject to recapture by the taxpayer under section 1254(a)(1) upon disposition of the remaining portion of the property. For example, assume that A owns an 80-acre tract of land with respect to which A has deducted intangible drilling and development costs under section 263(c). If A sells the north 40 acres, the entire amount of the section 1254 costs with respect to the 80-acre tract is treated as allocable to the 40-acre portion sold (to the extent of the amount of gain to which section 1254(a)(1) applies).

(ii) *Natural resource recapture property subject to the exceptions and limitations of § 1.1254–2.* For purposes of section 1254(a)(1) and paragraph (a) of this section, except as provided in paragraph (b)(3) of this section, in the case of the disposition of a portion (that is not an undivided interest) of natural resource recapture property to which section 1254(a)(1) does not apply by reason of the application of § 1.1254–2 (certain nonrecognition transactions), the following rule for allocation of costs applies. An amount of the section 1254 costs that bears the same ratio to the entire amount of such costs with respect to the entire natural resource recapture property as the value of the property transferred bears to the value of the entire natural resource recapture property is treated as allocable to the portion of the natural resource recapture property transferred. The balance of the section 1254 costs remaining after allocation to that portion of the transferred property remains subject to recapture by the taxpayer under section 1254(a)(1) upon disposition of the remaining portion of the property. For example, assume that A owns an 80-acre tract of land with respect to which A has deducted intangible drilling and development costs under section 263(c). If A gives away the north 40 acres, and if 60 percent of the value of the 80-acre tract were attributable to the north 40 acres given away, 60 percent of the section 1254 costs with respect to the 80-acre tract is allocable to the north 40 acres given away.

(2) *Disposition of an undivided interest*—(i) *Natural resource recapture property subject to the general rules of § 1.1254–1.* For purposes of section 1254(a)(1), except as provided in paragraphs (b)(2)(ii) and (b)(3) of this section, in the case of the disposition of an undivided interest in natural resource recapture property (or a portion thereof), a proportionate part of the section 1254 costs with respect to the natural resource recapture property is treated as allocable to the transferred undivided interest to the extent of the amount of gain to which section 1254(a)(1) applies. For example, assume that A owns an 80-acre tract of land with respect to which A has deducted intangible drilling and development costs under section 263(c). If A sells an undivided 40 percent interest in the 80-acre tract, 40 percent of the section 1254 costs with respect to the 80-acre tract is allocable to the transferred 40 percent interest in the 80-acre tract. However, if the amount of gain recognized on the sale of the 40 percent undivided interest were equal to only 35 percent of the amount of section 1254 costs attributable to the 80-acre tract, only 35 percent of the section 1254 costs would be treated as attributable to the undivided 40 percent interest. See paragraph (c)(3) of this section for an alternative allocation rule.

(ii) *Natural resource recapture property subject to the exceptions and limitations of § 1.1254–2.* For purposes of section 1254(a)(1) and paragraph (a) of this section, except as provided in paragraph (b)(3) of this section, in the case of a disposition of an undivided interest in natural resource recapture property (or a portion thereof) to which section 1254 (a)(1) does not apply by reason of § 1.1254–2, a proportionate part of the section 1254 costs with respect to the natural resource recapture property is treated as allocable to the transferred undivided interest. See paragraph (c)(3) of this section for an alternative allocation rule.

(3) *Alternative allocation rule*—(i) *In general.* The rules for the allocation of costs set forth in section 1254(a)(2) and paragraphs (c) (1) and (2) of this section do not apply with respect to section 1254 costs that the taxpayer establishes to the satisfaction of the Commissioner

do not relate to the transferred property. Except as provided in paragraphs (c)(3) (ii) and (iii) of this section, a taxpayer may satisfy this requirement only by receiving a private letter ruling from the Internal Revenue Service that the section 1254 costs do not relate to the transferred property.

(ii) *Portion of property*. Upon the transfer of a portion of a natural resource recapture property (other than an undivided interest) with respect to which section 1254 costs have been incurred, a taxpayer may treat section 1254 costs as not relating to the transferred portion if the transferred portion does not include any part of any deposit with respect to which the costs were incurred.

(iii) *Undivided interest*. Upon the transfer of an undivided interest in a natural resource recapture property with respect to which section 1254 costs have been incurred, a taxpayer may treat costs as not relating to the transferred interest if the undivided interest is an undivided interest in a portion of the natural resource recapture property, and the portion would be eligible for the alternative allocation rule under paragraph (c)(3)(ii) of this section.

(iv) *Substantiation*. If a taxpayer treats section 1254 costs incurred with respect to a natural resource recapture property as not relating to a transferred interest in a portion of the property, the taxpayer must indicate on his or her tax return that the costs do not relate to the transferred portion and maintain the records and supporting evidence that substantiate this position.

(d) *Installment method*. Gain from a disposition to which section 1254(a)(1) applies is reported on the installment method if that method otherwise applies under section 453 or 453A of the Internal Revenue Code and the regulations thereunder. The portion of each installment payment as reported that represents income (other than interest) is treated as gain to which section 1254(a)(1) applies until all of the gain (to which section 1254(a)(1) applies) has been reported, and the remaining portion (if any) of the income is then treated as gain to which section 1254(a)(1) does not apply. For treatment of amounts as interest on certain deferred payments, see sections 483, 1274, and the regulations thereunder.

[T.D. 8586, 60 FR 2502, Jan. 10, 1995]

§ 1.1254–2 Exceptions and limitations.

(a) *Exception for gifts and section 1041 transfers*—(1) *General rule*. No gain is recognized under section 1254(a)(1) upon a disposition of natural resource recapture property by a gift or by a transfer in which no gain or loss is recognized pursuant to section 1041 (relating to transfers between spouses). For purposes of this paragraph (a), the term *gift* means, except to the extent that paragraph (a)(2) of this section applies, a transfer of natural resource recapture property that, in the hands of the transferee, has a basis determined under the provisions of section 1015(a) or 1015(d) (relating to basis of property acquired by gift) or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010). For rules concerning the potential reduction in the amount of the charitable contribution in the case of natural resource recapture property, see section 170(e) and § 1.170A–4. See § 1.1254–3(b)(1) for determination of potential recapture of section 1254 costs on property acquired by gift. See § 1.1254–1 (c)(1)(ii) and (c)(2)(ii) for apportionment of section 1254 costs on a gift of a portion of natural resource recapture property.

(2) *Part gift transactions*. If a disposition of natural resource recapture property is in part a sale or exchange and in part a gift, the gain that is treated as ordinary income pursuant to section 1254(a)(1) is the lower of the section 1254 costs with respect to the property or the excess of the amount realized upon the disposition of the property over the adjusted basis of the property. In the case of a transfer subject to section 1011(b) (relating to bargain sales to charitable organizations), the adjusted basis for purposes of the preceding sentence is the adjusted basis for determining gain or loss under section 1011(b).

(b) *Exception for transfers at death*. Except as provided in section 691 (relating to income in respect of a decedent), no gain is recognized under section 1254(a)(1) upon a transfer at death. For

purposes of this paragraph, the term *transfer at death* means a transfer of natural resource recapture property that, in the hands of the transferee, has a basis determined under the provisions of section 1014(a) (relating to basis of property acquired from a decedent) because of the death of the transferor. See § 1.1254–3 (a)(4) and (c) for the determination of potential recapture of section 1254 costs on property acquired in a transfer at death.

(c) *Limitation for certain tax-free transactions*—(1) *General rule*. Upon a transfer of property described in paragraph (c)(3) of this section, the amount of gain treated as ordinary income by the transferor under section 1254(a)(1) may not exceed the amount of gain recognized to the transferor on the transfer (determined without regard to section 1254). In the case of a transfer of both natural resource recapture property and property that is not natural resource recapture property in one transaction, the amount realized from the disposition of the natural resource recapture property is deemed to be equal to the amount that bears the same ratio to the total amount realized as the fair market value of the natural resource recapture property bears to the aggregate fair market value of all the property transferred. The preceding sentence is applied solely for purposes of computing the portion of the total gain (determined without regard to section 1254) that may be recognized as ordinary income under section 1254(a)(1).

(2) *Special rule for dispositions to certain tax-exempt organizations*. Paragraph (c)(1) of this section does not apply to a disposition of natural resource recapture property to an organization (other than a cooperative described in section 521) that is exempt from the tax imposed by chapter I of the Internal Revenue Code. The preceding sentence does not apply to a disposition of natural resource recapture property to an organization described in section 511 (a)(2) or (b)(2) (relating to imposition of tax on unrelated business income of charitable, etc., organizations) if, immediately after the disposition, the organization uses the property in an unrelated trade or business as defined in section 513. If any property with respect to which gain is not recognized by reason of the exception of this paragraph (c)(2) ceases to be used in an unrelated trade or business of the organization acquiring the property, that organization is, for purposes of section 1254, treated as having disposed of the property on the date of the cessation.

(3) *Transfers described*. The transfers referred to in paragraph (c)(1) of this section are transfers of natural resource recapture property in which the basis of the natural resource recapture property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(i) Section 332 (relating to certain liquidations of subsidiaries). See paragraph (c)(4) of this section.

(ii) Section 351 (relating to transfer to a corporation controlled by transferor).

(iii) Section 361 (relating to exchanges pursuant to certain corporate reorganizations).

(iv) Section 721 (relating to transfers to a partnership in exchange for a partnership interest).

(v) Section 731 (relating to distributions by a partnership to a partner). For purposes of this paragraph, the basis of natural resource recapture property distributed by a partnership to a partner is deemed to be determined by reference to the adjusted basis of such property to the partnership.

(4) *Special rules for section 332 transfers*. In the case of a distribution in complete liquidation of a subsidiary to which section 332 applies, the limitation provided in this paragraph (c) is confined to instances in which the basis of the natural resource recapture property in the hands of the transferee is determined, under section 334(b)(1), by reference to its basis in the hands of the transferor. Thus, for example, the limitation may apply in respect of a liquidating distribution of natural resource recapture property by a subsidiary corporation to the parent corporation, but does not apply in respect of a liquidating distribution of natural resource recapture property to a minority shareholder. This paragraph (c)

does not apply to a liquidating distribution of natural resource recapture property by a subsidiary to its parent if the parent's basis for the property is determined under section 334(b)(2) (as in effect before enactment of the Tax Reform Act of 1986), by reference to its basis for the stock of the subsidiary. This paragraph (c) does not apply to a liquidating distribution under section 332 of natural resource recapture property by a subsidiary to its parent if gain is recognized and there is a corresponding increase in the parent's basis in the property (e.g., certain distributions to a tax-exempt or foreign corporation).

(d) *Limitation for like kind exchanges and involuntary conversions*—(1) *General rule*. If natural resource recapture property is disposed of and gain (determined without regard to section 1254) is not recognized in whole or in part under section 1031 (relating to like kind exchanges) or section 1033 (relating to involuntary conversions), the amount of gain taken into account by the transferor under section 1254(a)(1) may not exceed the sum of—

(i) The amount of gain recognized on the disposition (determined without regard to section 1254); plus

(ii) The fair market value of property acquired that is not natural resource recapture property (determined without regard to §1.1254–1(b)(2)(vii)) and is not taken into account under paragraph (d)(1)(i) of this section (that is, qualifying property under section 1031 or 1033 that is not natural resource recapture property).

(2) *Disposition and acquisition of both natural resource recapture property and other property*. For purposes of this paragraph (d), if both natural resource recapture property and property that is not natural resource recapture property are acquired as the result of one disposition in which both natural resource recapture property and property that is not natural resource recapture property are disposed of—

(i) The total amount realized upon the disposition is allocated between the natural resource recapture property and the property that is not natural resource recapture property disposed of in proportion to their respective fair market values;

(ii) The amount realized upon the disposition of the natural resource recapture property is deemed to consist of so much of the fair market value of the natural resource recapture property acquired as is not in excess of the amount realized from the natural resource recapture property disposed of, and the remaining portion (if any) of the amount realized upon the disposition of such property is deemed to consist of so much of the fair market value of the property that is not natural resource recapture property acquired as is not in excess of the remaining portion; and

(iii) The amount realized upon the disposition of the property that is not natural resource recapture property is deemed to consist of so much of the fair market value of all the property acquired which was not taken into account under paragraph (d)(2)(ii) of this section. Except as provided in section 1060 and the regulations thereunder, if a buyer and seller have adverse interests as to such allocation of the amount realized, any arm's-length agreement between the buyer and seller is used to establish the allocation. In the absence of such an agreement, the allocation is made by taking into account the appropriate facts and circumstances.

[T.D. 8586, 60 FR 2505, Jan. 10, 1995, as amended by T.D. 8684, 61 FR 53063, Oct. 10, 1996; T.D. 9811, 82 FR 6241, Jan. 19, 2017]

§ 1.1254–3 Section 1254 costs immediately after certain acquisitions.

(a) *Transactions in which basis is determined by reference to cost or fair market value of property transferred*—(1) *Basis determined under section 1012*. If, on the date a person acquires natural resource recapture property, the person's basis for the property is determined solely by reference to its cost (within the meaning of section 1012), the amount of section 1254 costs with respect to the natural resource recapture property in the person's hands is zero on the acquisition date.

(2) *Basis determined under section 301(d), 334(a), or 358(a)(2)*. If, on the date a person acquires natural resource recapture property, the person's basis for the property is determined solely by reason of the application of section

301(d) (relating to basis of property received in a corporate distribution), section 334(a) (relating to basis of property received in a liquidation in which gain or loss is recognized), or section 358(a)(2) (relating to basis of other property received in certain exchanges), the amount of the section 1254 costs with respect to the natural resource recapture property in the person's hands is zero on the acquisition date.

(3) *Basis determined solely under former section 334(b)(2) or former section 334(c).* If, on the date a person acquires natural resource recapture property, the person's basis for the property is determined solely under the provisions of section 334(b)(2) (prior to amendment of that section by the Tax Equity and Fiscal Responsibility Act of 1982) or (c) (prior to repeal of that section by the Tax Reform Act of 1986) (relating to basis of property received in certain corporate liquidations), the amount of section 1254 costs with respect to the natural resource recapture property in the person's hands is zero on the acquisition date.

(4) *Basis determined by reason of the application of section 1014(a).* If, on the date a person acquires natural resource recapture property from a decedent, the person's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), the amount of section 1254 costs with respect to the natural resource recapture property in the person's hands is zero on the acquisition date. See paragraph (c) of this section for the treatment of certain transfers at death.

(b) *Gifts and certain tax-free transactions*—(1) *General rule.* If natural resource recapture property is transferred in a transaction described in paragraph (b)(2) of this section, the amount of section 1254 costs with respect to the natural resource recapture property in the hands of the transferee immediately after the disposition is an amount equal to—

(i) The amount of section 1254 costs with respect to the natural resource recapture property in the hands of the transferor immediately before the disposition (and in the case of an S corporation or partnership transferor, the section 1254 costs of the shareholders or partners with respect to the natural resource recapture property); minus

(ii) The amount of any gain taken into account as ordinary income under section 1254(a)(1) by the transferor upon the disposition (and in the case of an S corporation or partnership transferor, any such gain taken into account as ordinary income by the shareholders or partners).

(2) *Transactions covered.* The transactions to which paragraph (b)(1) of this section apply are—

(i) A disposition that is a gift or in part a sale or exchange and in part a gift;

(ii) A transaction described in section 1041(a);

(iii) A disposition described in § 1.1254–2(c)(3) (relating to certain tax-free transactions); or

(iv) A transfer at death where basis of property in the hands of the transferee is determined under section 1022.

(c) *Certain transfers at death.* If natural resource recapture property is acquired in a transfer at death, the amount of section 1254 costs with respect to the natural resource recapture property in the hands of the transferee immediately after the transfer includes the amount, if any, of the section 1254 costs deducted by the transferee before the decedent's death, to the extent that the basis of the natural resource recapture property (determined under section 1014(a)) is required to be reduced under the second sentence of section 1014(b)(9) (relating to adjustments to basis where the property is acquired from a decedent prior to death).

(d) *Property received in a like kind exchange or involuntary conversion*—(1) *General rule.* If natural resource recapture property is disposed of in a like kind exchange under section 1031 or involuntary conversion under section 1033, then immediately after the disposition the amount of section 1254 costs with respect to any natural resource recapture property acquired for the property transferred is an amount equal to—

(i) The amount of section 1254 costs with respect to the natural resource recapture property disposed of (including the section 1254 costs of the shareholders of an S corporation or of the partners of a partnership with respect to the natural resource recapture property); minus

(ii) The amount of any gain taken into account as ordinary income under section 1254(a)(1) by the transferor upon the disposition (and in the case of an S corporation or partnership transferor, any such gain taken into account as ordinary income by the shareholders or partners).

(2) *Allocation of section 1254 costs among multiple natural resource recapture properties acquired.* If more than one parcel of natural resource recapture property is acquired at the same time from the same person in a transaction referred to in paragraph (d)(1) of this section, the total amount of section 1254 costs with respect to the parcels is allocated to the parcels in proportion to their respective adjusted bases.

(e) *Property transferred in cases to which section 1071 or 1081(b) applies.* Rules similar to the rules of section 1245(b)(5) shall apply under section 1254.

[T.D. 8586, 60 FR 2506, Jan. 10, 1995, as amended by T.D. 8684, 61 FR 53063, Oct. 10, 1996; T.D. 9811, 82 FR 6242, Jan. 19, 2017]

§ 1.1254–4 Special rules for S corporations and their shareholders.

(a) *In general.* This section provides rules for applying the provisions of section 1254 to S corporations and their shareholders upon the disposition by an S corporation (and a corporation that was formerly an S corporation) of natural resource recapture property and upon the disposition by a shareholder of stock of an S corporation that holds natural resource recapture property.

(b) *Determination of gain treated as ordinary income under section 1254 upon a disposition of natural resource recapture property by an S corporation*—(1) *General rule.* Upon a disposition of natural resource recapture property by an S corporation, the amount of gain treated as ordinary income under section 1254 is determined at the shareholder level. Each shareholder must recognize as ordinary income under section 1254 the lesser of—

(i) The shareholder's section 1254 costs with respect to the property disposed of; or

(ii) The shareholder's share of the amount, if any, by which the amount realized on the sale, exchange, or involuntary conversion, or the fair market value of the property upon any other disposition (including a distribution), exceeds the adjusted basis of the property.

(2) *Examples.* The following examples illustrate the provisions of paragraph (b)(1) of this section:

Example 1. Disposition of natural resource recapture property other than oil and gas property. A and B are equal shareholders in X, an S corporation. On January 1, 1997, X acquires for $90,000 an undeveloped mineral property, its sole property. During 1997, X expends and deducts $100,000 in developing the property. On January 15, 1998, X sells the property for $250,000 when X's basis in the property is $90,000. Thus, X recognizes gain of $160,000 on the sale. A and B's share of the $160,000 gain recognized is $80,000 each. Each shareholder has $50,000 of section 1254 costs with respect to the property. Under these circumstances, A and B each are required to recognize $50,000 of the $80,000 of gain on the sale of the property as ordinary income under section 1254.

Example 2. Disposition of oil and gas property the adjusted basis of which is allocated to the shareholders under section 613A(c)(11). C and D are equal shareholders in Y, an S corporation. On January 1, 1997, Y acquires for $150,000 an undeveloped oil and gas property, its sole property. During 1997, Y expends in developing the property $40,000 in intangible drilling costs which it elects to expense under section 263(c). On January 15, 1998, Y sells the property for $200,000. C and D's share of the $200,000 amount realized on the sale is $100,000 each. C and D each have a basis of $75,000 in the property and $20,000 of section 1254 costs with respect to the property. Under these circumstances, C and D each are required to recognize $20,000 of the $25,000 gain on the sale of the property as ordinary income under section 1254.

(c) *Character of gain recognized by a shareholder upon a sale or exchange of S corporation stock*—(1) *General rule.* Except as provided in paragraph (c)(2) of this section, if an S corporation shareholder recognizes gain upon a sale or exchange of stock in the S corporation (determined without regard to section

1254), the gain is treated as ordinary income under section 1254 to the extent of the shareholder's section 1254 costs (with respect to the shares sold or exchanged).

(2) *Exceptions*—(i) *Gain not attributable to section 1254 costs*—(A) *General rule.* Paragraph (c)(1) of this section does not apply to any portion of the gain recognized on the sale or exchange of the stock that the taxpayer establishes is not attributable to section 1254 costs. The portion of the gain recognized that is not attributable to section 1254 costs is that portion of the gain recognized that exceeds the amount of ordinary income that the shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) if, immediately prior to the sale or exchange of the stock, the corporation had sold at fair market value all of the corporation's property the disposition of which would result in the recognition by the shareholder of ordinary income under section 1254.

(B) *Substantiation.* To establish that a portion of the gain recognized is not attributable to a shareholder's section 1254 costs so as to qualify for the exception contained in paragraph (c)(2)(i)(A) of this section, the shareholder must attach to the shareholder's tax return a statement detailing the shareholder's share of the fair market value and basis, and the shareholder's section 1254 costs, for each of the S corporation's natural resource recapture properties held immediately before the sale or exchange of stock.

(ii) *Transactions entered into as part of a plan to avoid recognition of ordinary income under section 1254.* In the case of a contribution of property prior to a sale or exchange of stock pursuant to a plan a principal purpose of which is to avoid recognition of ordinary income under section 1254, paragraph (c)(1) of this section does not apply. Instead, the amount recognized as ordinary income under section 1254 is the amount of ordinary income the selling or exchanging shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) had the S corporation sold its natural resource recapture property the disposition of which would have resulted in the recognition of ordinary income under section 1254. The amount recognized as ordinary income under the preceding sentence reduces the amount realized on the sale or exchange of the stock.

This reduced amount realized is used in determining any gain or loss on the sale or exchange.

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

Example 1. Application of general rule upon a sale of S corporation stock. C and D are equal shareholders in Y, an S corporation. As of January 1, 1997, Y holds two mining properties: Blackacre, with an adjusted basis of $5,000 and a fair market value of $35,000, and Whiteacre, with an adjusted basis of $20,000 and a fair market value of $15,000. Y also holds securities with a basis of $5,000 and a fair market value of $10,000. On January 1, 1997, D sells 50 percent of D's Y stock to E for $15,000. As of the date of the sale, D's adjusted basis in the Y stock sold is $7,500, and D has $18,000 of section 1254 costs with respect to Blackacre and $12,000 of section 1254 costs with respect to Whiteacre. Under this paragraph (c), the gain recognized by D upon the sale of Y stock is treated as ordinary income to the extent of D's section 1254 costs with respect to the stock sold, unless D establishes that a portion of such excess is not attributable to D's section 1254 costs. However, because D would recognize $7,500 in ordinary income under section 1254 with respect to the stock sold if Y sold Blackacre (the only asset the disposition of which would result in ordinary income to D under section 1254), the $7,500 of gain recognized by D upon the sale of D's Y stock is attributable to D's section 1254 costs. Therefore, upon the sale of stock to E, D recognizes $7,500 of ordinary income under this paragraph (c).

Example 2. Sale of S corporation stock where gain is not entirely attributable to section 1254 costs. Assume the same facts as in *Example 1,* except that Blackacre has a fair market value of $25,000, and the securities have a fair market value of $20,000. Immediately prior to the sale of stock to E, if Y had sold Blackacre (its only asset the disposition of which would result in the recognition of ordinary income to D under section 1254), D would recognize $5,000 in ordinary income with respect to the stock sold under section 1254. D attaches a statement to D's tax return for 1997 detailing D's share of the fair market values and bases, and D's section 1254 costs with respect to Blackacre and Whiteacre. Therefore, upon the sale of stock to E, of the $7,500 gain recognized by D, $5,000 is ordinary income under this paragraph (c).

Example 3. Contribution of property prior to sale of S corporation stock as part of a plan to

avoid recognition of ordinary income under section 1254. H owns all of the stock of Z, an S corporation. As of January 1, 1997, H has $3,000 of section 1254 costs with respect to property P, which is natural resource recapture property and Z's only asset. Property P has an adjusted basis of $5,000 and a fair market value of $8,000. H has a basis of $5,000 in Z stock, which has a fair market value of $8,000. On January 1, 1997, H contributes securities to Z which have a basis of $7,000 and a fair market value of $4,000. On April 15, 1997, H sells all of the Z stock to J for $12,000. On that date, H's adjusted basis in the Z stock is also $12,000. Based on all the facts and circumstances, the sale of stock is part of a plan (along with the contribution by H of the securities to Z) that has a principal purpose to avoid recognition of ordinary income under section 1254. Consequently, under paragraph (c)(2)(ii) of this section, H must recognize $3,000 as ordinary income under section 1254, the amount of ordinary income that H would recognize as ordinary income under section 1254 if property P were sold at fair market value. In addition, H reduces the amount realized on the sale of the stock ($12,000) by $3,000. As a result, H also recognizes a $3,000 capital loss on the sale of the stock ($9,000 amount realized less $12,000 adjusted basis).

(d) *Section 1254 costs of a shareholder.* An S corporation shareholder's section 1254 costs with respect to any natural resource recapture property held by the corporation include all of the shareholder's section 1254 costs with respect to the property in the hands of the S corporation. See §1.1254–1(b)(1) for the definition of section 1254 costs.

(e) *Section 1254 costs of an acquiring shareholder after certain acquisitions*—(1) *Basis determined under section 1012.* If stock in an S corporation that holds natural resource recapture property is acquired and the acquiring shareholder's basis for the stock is determined solely by reference to its cost (within the meaning of section 1012), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands is zero on the acquisition date.

(2) *Basis determined under section 1014(a).* If stock in an S corporation that holds natural resource recapture property is acquired from a decedent and the acquiring shareholder's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the stock on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands is zero on the acquisition date.

(3) *Basis determined under section 1014(b)(9).* If stock in an S corporation that holds natural resource recapture property is acquired before the death of the decedent, the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands includes the amount, if any, of the section 1254 costs deducted by the acquiring shareholder before the decedent's death, to the extent that the basis of the stock (determined under section 1014(a)) is required to be reduced under section 1014(b)(9) (relating to adjustments to basis when the property is acquired before the death of the decedent).

(4) *Gifts and section 1041 transfers.* If stock is acquired in a transfer that is a gift, in a transfer that is a part sale or exchange and part gift, in a transfer that is described in section 1041(a), or in a transfer at death where the basis of property in the hands of the transferee is determined under section 1022, the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands immediately after the transfer is an amount equal to—

(i) The amount of section 1254 costs with respect to the property held by the corporation in the hands of the transferor immediately before the transfer; minus

(ii) The amount of any gain recognized as ordinary income under section 1254 by the transferor upon the transfer.

(f) *Special rules for a corporation that was formerly an S corporation or formerly a C corporation*—(1) *Section 1254 costs of an S corporation that was formerly a C corporation.* In the case of a C corporation that holds natural resource recapture property and that elects to be an S corporation, each shareholder's section 1254 costs as of the beginning of the corporation's first taxable year as an S corporation include a pro rata share of the section 1254 costs of the corporation as of the close of the last

taxable year that the corporation was a C corporation.

(2) *Examples*. The following examples illustrate the application of the provisions of paragraph (f)(1) of this section:

Example 1. Sale of natural resource recapture property held by an S corporation that was formerly a C corporation. (i) Y is a C corporation that elects to be an S corporation effective January 1, 1997. On that date, Y owns Oil Well, which is natural resource recapture property and a capital asset. Y has section 1254 costs of $20,000 as of the close of the last taxable year that it was a C corporation. On January 1, 1997, Oil Well has a value of $200,000 and a basis of $100,000. Thus, under section 1374, Y's net unrealized built-in gain is $100,000. Also on that date, Y's basis in Oil Well is allocated to A, Y's sole shareholder, under section 613A(c)(11) and the section 1254 costs are allocated to A under paragraph (f)(1) of this section. In addition, A has a basis in A's Y stock of $100,000.

(ii) On November 1, 1997, Y sells Oil Well for $250,000. During 1997, Y has taxable income greater than $100,000, and no other transactions or items treated as recognized built-in gain or loss. Under section 1374, Y has net recognized built-in gain of $100,000. Assuming a tax rate of 35 percent on capital gain, Y has a tax of $35,000 under section 1374. The tax of $35,000 is treated as a capital loss under section 1366(f)(2). A has a realized gain on the sale of $150,000 ($250,000 minus $100,000) of which $20,000 is recognized as ordinary income under section 1254, and $130,000 is recognized as capital gain. Consequently, A recognizes ordinary income of $20,000 and net capital gain of $95,000 ($130,000 minus $35,000) on the sale.

Example 2. Sale of stock followed by sale of natural resource recapture property held by an S corporation that was formerly a C corporation. (i) Assume the same facts as in *Example 1*(i). On November 1, 1997, A sells all of A's Y stock to P for $250,000. A has a realized gain on the sale of $150,000 ($250,000 minus $100,000) of which $20,000 is recognized as ordinary income under section 1254, and $130,000 is recognized as capital gain.

(ii) On November 2, 1997, Y sells Oil Well for $250,000. During 1997, Y has taxable income greater than $100,000, and no other transactions or items treated as recognized built-in gain or loss. Under section 1374, Y has net recognized built-in gain of $100,000. Assuming a tax rate of 35 percent on capital gain, Y has a tax of $35,000 under section 1374. The tax of $35,000 is treated as a capital loss under section 1366(f)(2). P has a realized gain on the sale of $150,000 ($250,000 minus $100,000), which is recognized as capital gain. Consequently, P recognizes net capital gain of $115,000 ($150,000 minus $35,000) on the sale.

(3) *Section 1254 costs of a C corporation that was formerly an S corporation*. In the case of an S corporation that becomes a C corporation, the C corporation's section 1254 costs with respect to any natural resource recapture property held by the corporation as of the beginning of the corporation's first taxable year as a C corporation include the sum of its shareholders' section 1254 costs with respect to the property as of the close of the last taxable year that the corporation was an S corporation. In the case of an S termination year as defined in section 1362(e)(4), the shareholders' section 1254 costs are determined as of the close of the S short year as defined in section 1362(e)(1)(A). See paragraph (g)(5) of this section for rules on determining the aggregate amount of the shareholders' section 1254 costs.

(g) *Determination of a shareholder's section 1254 costs upon certain stock transactions*—(1) *Issuance of stock*. Upon an issuance of stock (whether such stock is newly-issued or had been held as treasury stock) by an S corporation in a reorganization described in section 368 or otherwise—

(i) Each recipient of shares must be allocated a pro rata share (determined solely with respect to the shares issued in the transaction) of the aggregate of the S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation immediately before the issuance (as determined pursuant to paragraph (g)(5) of this section); and

(ii) Each pre-existing shareholder must reduce his or her section 1254 costs with respect to natural resource recapture property held by the S corporation immediately before the issuance by an amount equal to the pre-existing shareholder's section 1254 costs immediately before the issuance multiplied by the percentage of stock of the corporation issued in the transaction.

(2) *Natural resource recapture property acquired in exchange for stock*. If natural resource recapture property is transferred to an S corporation in exchange for stock of the S corporation (for example, in a section 351 transaction, or in a reorganization described in section 368), the S corporation must allocate to

its shareholders a pro rata share of the S corporation's section 1254 costs with respect to the property immediately after the transaction (as determined under § 1.1254–3(b)(1)).

(3) *Treatment of nonvested stock.* Stock issued in connection with the performance of services that is substantially nonvested (within the meaning of § 1.83–3(b)) is treated as issued for purposes of this section at the first time it is treated as outstanding stock of the S corporation for purposes of section 1361.

(4) *Exception.* Paragraph (g)(1) of this section does not apply to stock issued in exchange for stock of the same S corporation (as for example, in a recapitalization described in section 368(a)(1)(E)).

(5) *Aggregate of S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation*—(i) *In general.* The aggregate of S corporation shareholders' section 1254 costs is equal to the sum of each shareholder's section 1254 costs. The S corporation must determine each shareholder's section 1254 costs under either paragraph (g)(5)(ii) (written data) or paragraph (g)(5)(iii) (assumptions) of this section. The S corporation may determine the section 1254 costs of some shareholders under paragraph (g)(5)(ii) of this section and of others under paragraph (g)(5)(iii) of this section.

(ii) *Written data.* An S corporation may determine a shareholder's section 1254 costs by using written data provided by a shareholder showing the shareholder's section 1254 costs with respect to natural resource recapture property held by the S corporation unless the S corporation knows or has reason to know that the written data is inaccurate. If an S corporation does not receive written data upon which it may rely, the S corporation must use the assumptions provided in paragraph (g)(5)(iii) of this section in determining a shareholder's section 1254 costs.

(iii) *Assumptions.* An S corporation that does not use written data pursuant to paragraph (g)(5)(ii) of this section to determine a shareholder's section 1254 costs must use the following assumptions to determine the shareholder's section 1254 costs—

(A) The shareholder deducted his or her share of the amount of deductions under sections 263(c), 616, and 617 in the first year in which the shareholder could claim a deduction for such amounts, unless in the case of expenditures under sections 263(c) or 616 the S corporation elected to capitalize such amounts;

(B) The shareholder was not subject to the following limitations with respect to the shareholder's depletion allowance under section 611, except to the extent a limitation applied at the corporate level: the taxable income limitation of section 613(a); the depletable quantity limitations of section 613A(c); or the limitations of sections 613A(d)(2), (3), and (4) (exclusion of retailers and refiners).

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

Example 1. Transfer of natural resource recapture property to an S corporation in a section 351 transaction. As of January 1, 1997, A owns all the stock (20 shares) in X, an S corporation. X holds property that is not natural resource recapture property that has a fair market value of $2,000 and an adjusted basis of $2,000. On January 1, 1997, B transfers natural resource recapture property, Property P, to X in exchange for 80 shares of X stock in a transaction that qualifies under section 351. Property P has a fair market value of $8,000 and an adjusted basis of $5,000. Pursuant to section 351, B does not recognize gain on the transaction. Immediately prior to the transaction, B's section 1254 costs with respect to Property P equaled $6,000. Under § 1.1254–2(c)(1), B does not recognize any gain under section 1254 on the section 351 transaction and, under § 1.1254–3(b)(1), X's section 1254 costs with respect to Property P immediately after the contribution equal $6,000. Under paragraph (g)(2) of this section, each shareholder is allocated a pro rata share of X's section 1254 costs. The pro rata share of X's section 1254 costs that is allocated to A equals $1,200 (20 percent interest in X multiplied by X's $6,000 of section 1254 costs). The pro rata share of X's section 1254 costs that is allocated to B equals $4,800 (80 percent interest in X multiplied by X's $6,000 of section 1254 costs).

Example 2. Contribution of money in exchange for stock of an S corporation holding natural resource recapture property. As of January 1, 1997, A and B each own 50 percent of the stock (50 shares each) in X, an S corporation. X holds natural resource recapture property, Property P, which has a fair market value of $20,000 and an adjusted basis of

$14,000. A's and B's section 1254 costs with respect to Property P are $4,000 and $1,500, respectively. On January 1, 1997, C contributes $20,000 to X in exchange for 100 shares of X's stock. Under paragraph (g)(1)(i) of this section, X must allocate to C a pro rata share of its shareholders' section 1254 costs. Using the assumptions set forth in paragraph (g)(5)(iii) of this section, X determines that A's section 1254 costs with respect to natural resource recapture property held by X equal $4,500. Using written data provided by B, X determines that B's section 1254 costs with respect to Property P equal $1,500. Thus, the aggregate of X's shareholders' section 1254 costs equals $6,000. C's pro rata share of the $6,000 of section 1254 costs equals $3,000 (C's 50 percent interest in X multiplied by $6,000). Under paragraph (g)(1)(ii) of this section, A's section 1254 costs are reduced by $2,000 (A's actual section 1254 costs ($4,000) multiplied by 50 percent). B's section 1254 costs are reduced by $750 (B's actual section 1254 costs ($1,500) multiplied by 50 percent).

Example 3. Merger involving an S corporation that holds natural resource recapture property. X, an S corporation with one shareholder, A, holds as its sole asset natural resource recapture property that has a fair market value of $120,000 and an adjusted basis of $40,000. A has section 1254 costs with respect to the property of $60,000. For valid business reasons, X merges into Y, an S corporation with one shareholder, B, in a reorganization described in section 368(a)(1)(A). Y holds property that is not natural resource recapture property that has a fair market value of $120,000 and basis of $120,000. Under paragraph (c) of this section, A does not recognize ordinary income under section 1254 upon the exchange of stock in the merger because A did not otherwise recognize gain on the merger. Under paragraph (g)(2) of this section, Y must allocate to A and B a pro rata share of its $60,000 of section 1254 costs. Thus, A and B are each allocated $30,000 of section 1254 costs (50 percent interest in X, each, multiplied by $60,000).

[T.D. 8684, 61 FR 53063, Oct. 10, 1996, as amended by T.D. 9811, 82 FR 6242, Jan. 19, 2017]

§ 1.1254–5 Special rules for partnerships and their partners.

(a) *In general.* This section provides rules for applying the provisions of section 1254 to partnerships and their partners upon the disposition of natural resource recapture property by the partnership and certain distributions of property by a partnership. See section 751 and the regulations thereunder for rules concerning the treatment of gain upon the transfer of a partnership interest.

(b) *Determination of gain treated as ordinary income under section 1254 upon the disposition of natural resource recapture property by a partnership*—(1) *General rule.* Upon a disposition of natural resource recapture property by a partnership, the amount treated as ordinary income under section 1254 is determined at the partner level. Each partner must recognize as ordinary income under section 1254 the lesser of—

(i) The partner's section 1254 costs with respect to the property disposed of; or

(ii) The partner's share of the amount, if any, by which the amount realized upon the sale, exchange, or involuntary conversion, or the fair market value of the property upon any other disposition, exceeds the adjusted basis of the property.

(2) *Exception to partner level recapture in the case of abusive allocations.* Paragraph (b)(1) of this section does not apply in determining the amount treated as ordinary income under section 1254 upon a disposition of section 1254 property by a partnership if the partnership has allocated the amount realized or gain recognized from the disposition with a principal purpose of avoiding the recognition of ordinary income under section 1254. In such case, the amount of gain on the disposition recaptured as ordinary income under section 1254 is determined at the partnership level.

(3) *Examples.* The provisions of paragraphs (a) and (b) of this section are illustrated by the following examples which assume that capital accounts are maintained in accordance with section 704(b) and the regulations thereunder:

Example 1. Partner level recapture—In general. A, B, and C, have equal interests in capital in Partnership ABC that was formed on January 1, 1985. The partnership acquired an undeveloped domestic oil property on January 1, 1985, for $120,000. The partnership allocated the property's basis to each partner in proportion to the partner's interest in partnership capital, so each partner was allocated $40,000 of basis. In 1985, the partnership incurred $60,000 of productive well intangible drilling and development costs with respect to the property. The partnership elected to deduct the intangible drilling and development costs as expenses under section 263(c).

Each partner deducted $20,000 of the intangible drilling and development costs. Assume that depletion allowable under section 613A(c)(7)(D) for each partner for 1985 was $10,000. On January 1, 1986, the partnership sold the oil property to an unrelated third party for $210,000. Each partner's allocable share of the amount realized is $70,000. Each partner's basis in the oil property at the end of 1985 is $30,000 ($40,000 cost—$10,000 depletion deductions claimed). Each partner has a gain of $40,000 on the sale of the oil property ($70,000 amount realized—$30,000 adjusted basis in the oil property). Assume that each partner's depletion allowance would not have been increased if the intangible drilling and development costs had been capitalized. Each partner's section 1254 costs with respect to the property are $20,000. Thus, A, B, and C each must treat $20,000 of gain recognized as ordinary income under section 1254(a).

Example 2. Special allocation of intangible drilling and development costs. K and L form a partnership on January 1, 1997, to acquire and develop a geothermal property as defined under section 613(e)(2). The partnership agreement provides that all intangible drilling and development costs will be allocated to partner K, and that all other items of income, gain, or loss will be allocated equally between the two partners. Assume these allocations have substantial economic effect under section 704(b) and the regulations thereunder. The partnership acquires a lease covering undeveloped acreage located in the United States for $50,000. In 1997, the partnership incurs $50,000 of intangible drilling and development costs that are allocated to partner K. The partnership also has $30,000 of depletion deductions, which are allocated equally between K and L. On January 1, 1998, the partnership sells the geothermal property to an unrelated third party for $160,000 and recognizes a gain of $140,000 ($160,000 amount realized less $20,000 adjusted basis ($50,000 unadjusted basis less $30,000 depletion deductions)). This gain is allocated equally between K and L. Because K's section 1254 costs are $65,000 and L's section 1254 costs are $15,000, K recognizes $65,000 as ordinary income under section 1254(a) and L recognizes $15,000 as ordinary income under section 1254(a). The remaining $5,000 of gain allocated to K and $55,000 of gain allocated to L is characterized without regard to section 1254.

Example 3. Section 59(e) election to capitalize intangible drilling and development costs. Partnership DK has 50 equal partners. On January 1, 1995, the partnership purchases an undeveloped oil and gas property for $100,000. The partnership allocates the property's basis equally among the partners, so each partner is allocated $2,000 of basis. In January 1995, the partnership incurs $240,000 of intangible drilling and development costs with respect to the property. The partnership elects to deduct the intangible drilling and development costs as expenses under section 263(c). Each partner is allocated $4,800 of intangible drilling and development costs. One of the partners, H, elects under section 59(e) to capitalize his $4,800 share of intangible drilling and development costs. Therefore, H is permitted to amortize his $4,800 share of intangible drilling and development costs over 60 months. H takes a $960 amortization deduction in 1995. Each of the remaining 49 partners deducts his $4,800 share of intangible drilling and development costs in 1995. Assume that depletion allowable for each partner under section 613A(c)(7)(D) for 1995 is $1,000. On December 31, 1995, the partnership sells the property for $300,000. Each partner is allocated $6,000 of amount realized. Each partner that deducted the intangible drilling and development costs has a basis in the oil property at the end of 1995 of $1,000 ($2,000 cost − $1,000 depletion deductions claimed). Each of these partners has a gain of $5,000 on the sale of the oil property ($6,000 amount realized − $1,000 adjusted basis in the property). The section 1254 costs of each partner that deducted intangible drilling and development costs are $5,800 ($4,800 intangible drilling and development costs deducted + $1,000 depletion deductions claimed). Because each partner's section 1254 costs ($5,800) exceed each partner's share of amount realized less each partner's adjusted basis ($5,000), each partner must treat his $5,000 gain recognized on the sale of the oil property as ordinary income under section 1254(a). Because H elected under section 59(e) to capitalize the $4,800 of intangible drilling and development costs and amortized only $960 of the costs in 1995, the $3,840 of unamortized intangible drilling and development costs are included in H's basis in the oil property. Therefore, at the end of 1995 H's basis in the oil property is $4,840 (($2,000 cost + $4,800 capitalized intangible drilling and development costs) − ($960 intangible drilling and development costs amortized + $1,000 depletion deduction claimed)). H's gain on the sale of the oil property is $1,160 ($6,000 amount realized − $4,840 adjusted basis). H's section 1254 costs are $1,960 ($960 intangible drilling and development costs amortized + $1,000 depletion deductions claimed). Because H's section 1254 costs ($1,960) exceed H's share of amount realized less H's adjusted basis ($1,160), H must treat the $1,160 of gain recognized as ordinary income under section 1254(a).

(c) *Section 1254 costs of a partner*—(1) *General rule.* A partner's section 1254 costs with respect to property held by a partnership include all of the partner's section 1254 costs with respect to

the property in the hands of the partnership. In the case of property contributed to a partnership in a transaction described in section 721, a partner's section 1254 costs include all of the partner's section 1254 costs with respect to the property prior to contribution. Section 1.1254–1(b)(1)(iv), which provides rules concerning the treatment of suspended deductions, applies to amounts not deductible pursuant to section 704(d).

(2) *Section 1254 costs of a transferee partner after certain acquisitions*—(i) *Basis determined under section 1012.* If a person acquires an interest in a partnership that holds natural resource recapture property (transferee partner) and the transferee partner's basis for the interest is determined by reference to its cost (within the meaning of section 1012), the amount of the transferee partner's section 1254 costs with respect to the property held by the partnership is zero on the acquisition date.

(ii) *Basis determined by reason of the application of section 1014(a).* If a transferee partner acquires an interest in a partnership that holds natural resource recapture property from a decedent and the transferee partner's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the partnership interest on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), the amount of the transferee partner's section 1254 costs with respect to property held by the partnership is zero on the acquisition date.

(iii) *Basis determined by reason of the application of section 1014(b)(9).* If an interest in a partnership that holds natural resource recapture property is acquired before the death of the decedent, the amount of the transferee partner's section 1254 costs with respect to property held by the partnership shall include the amount, if any, of the section 1254 costs deducted by the transferee partner before the decedent's death, to the extent that the basis of the partner's interest (determined under section 1014(a)) is required to be reduced under section 1014(b)(9) (relating to adjustments to basis when the property is acquired before the death of the decedent).

(iv) *Gifts and section 1041 transfers.* If an interest in a partnership is transferred in a transfer that is a gift, in a transfer that is a part sale or exchange and part gift, in a transfer that is described in section 1041(a), or in a transfer at death where the basis of property in the hands of the transferee is determined under section 1022, the amount of the transferee partner's section 1254 costs with respect to property held by the partnership immediately after the transfer is an amount equal to—

(A) The amount of the transferor partner's section 1254 costs with respect to the property immediately before the transfer; minus

(B) The amount of any gain recognized as ordinary income under section 1254 by the transferor partner upon the transfer.

(d) *Property distributed to a partner*—(1) *In general.* The section 1254 costs for any natural resource recapture property received by a partner in a distribution with respect to part or all of an interest in a partnership include—

(i) The aggregate of the partners' section 1254 costs with respect to the natural resource recapture property immediately prior to the distribution; reduced by

(ii) The amount of any gain taken into account as ordinary income under section 751 by the partnership or the partners (as constituted after the distribution) on the distribution of the natural resource recapture property.

(2) *Aggregate of partners' section 1254 costs with respect to natural resource recapture property held by a partnership*—(i) *In general.* The aggregate of partners' section 1254 costs is equal to the sum of each partner's section 1254 costs. The partnership must determine each partner's section 1254 costs under either paragraph (d)(2)(i)(A) (written data) or paragraph (d)(2)(i)(B) (assumptions) of this section. The partnership may determine the section 1254 costs of some of the partners under paragraph (d)(2)(i)(A) of this section and of others under paragraph (d)(2)(i)(B) of this section.

(A) *Written data.* A partnership may determine a partner's section 1254 costs by using written data provided by a

partner showing the partner's section 1254 costs with respect to natural resource recapture property held by the partnership unless the partnership knows or has reason to know that the written data is inaccurate. If a partnership does not receive written data upon which it may rely, the partnership must use the assumptions provided in paragraph (d)(2)(i)(B) of this section in determining a partner's section 1254 costs.

(B) *Assumptions.* A partnership that does not use written data pursuant to paragraph (d)(2)(i)(A) of this section to determine a partner's section 1254 costs must use the following assumptions to determine the partner's section 1254 costs:

(*1*) The partner deducted his or her share of deductions under section 263(c), 616, or 617 for the first year in which the partner could claim a deduction for such amounts, unless in the case of expenditures under section 263(c) or 616, the partnership elected to capitalize such amounts;

(*2*) The partner was not subject to the following limitations with respect to the partner's depletion allowance under section 611, except to the extent a limitation applied at the partnership level: the taxable income limitation of section 613(a); the depletable quantity limitations of section 613A(c); or the limitations of section 613A(d)(2), (3), and (4) (exclusion of retailers and refiners).

[T.D. 8586, 60 FR 2507, Jan. 10, 1995, as amended by T.D. 9811, 82 FR 6242, Jan. 19, 2017]

§ 1.1254–6 Effective/applicability date.

(a) Sections 1.1254–1 through 1.1254–3 and 1.1254–5 are effective with respect to any disposition of natural resource recapture property occurring after March 13, 1995. The rule in §1.1254–1(b)(2)(iv)(A)(*2*), relating to a nonoperating mineral interest carved out of an operating mineral interest with respect to which an expenditure has been deducted, is effective with respect to any disposition occurring after March 13, 1995, of property (within the meaning of section 614) that is placed in service by the taxpayer after December 31, 1986. Section 1.1254–4 applies to dispositions of natural resource recapture property by an S corporation (and a corporation that was formerly an S corporation) and dispositions of S corporation stock occurring on or after October 10, 1996. Sections 1.1254–2(d)(1)(ii) and 1.1254–3(b)(1)(i), (b)(1)(ii), (d)(1)(i), and (d)(1)(ii) are effective for dispositions of property occurring on or after October 10, 1996.

(b) The provisions of §§1.1254–2(a)(1), 1.1254–3(b)(2), 1.1254–4(e)(4), and 1.1254–5(c)(2)(iv) that relate to section 1022 are effective on and after January 19, 2017.

[T.D. 9811, 82 FR 6242, Jan. 19, 2017]

§ 1.1256(e)–1 Identification of hedging transactions.

(a) *Identification and recordkeeping requirements.* Under section 1256(e)(2), a taxpayer that enters into a hedging transaction must identify the transaction as a hedging transaction before the close of the day on which the taxpayer enters into the transaction.

(b) *Requirements for identification.* The identification of a hedging transaction for purposes of section 1256(e)(2) must satisfy the requirements of §1.1221–2(f)(1). Solely for purposes of section 1256(f)(1), however, an identification that does not satisfy all of the requirements of §1.1221–2(f)(1) is nevertheless treated as an identification under section 1256(e)(2).

(c) *Consistency with §1.1221–2.* Any identification for purposes of §1.1221–2(f)(1) is also an identification for purposes of this section. If a taxpayer satisfies the requirements of §1.1221–2(g)(1)(ii), the transaction is treated as if it were not identified as a hedging transaction for purposes of section 1256(e)(2).

(d) *Effective date.* The rules of this section apply to transactions entered into on or after March 20, 2002.

[T.D. 8985, 67 FR 12870, Mar. 20, 2002; 67 FR 31955, May 13, 2002]

§ 1.1256(e)–2 Special rules for syndicates.

(a) *Allocation of losses.* For purposes of section 1256(e)(3), *syndicate* means any partnership or other entity (other than a corporation that is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocated to limited partners

or limited entrepreneurs (within the meaning of section 461(k)(4)).

(b) *Determination of loss amount.* For purposes of section 1256(e)(3), the amount of losses to be allocated under paragraph (a) of this section is calculated without regard to section 163(j).

(c) *Example.* The following example illustrates the rules in this section:

(1) *Facts.* Entity is an S corporation that is equally owned by individuals A and B. A provides all of the goods and services provided by Entity. B provided all of the capital for Entity but does not participate in Entity's business. For the current taxable year, Entity has gross receipts of $5,000,000, non-interest expenses of $4,500,000, and interest expense of $600,000.

(2) *Analysis.* Under paragraph (b) of this section, Entity has a net loss of $100,000 ($5,000,000 minus $5,100,000) for the current taxable year. One half (50 percent) of this loss is allocated to B, a limited owner. Therefore, for the current taxable year, Entity is a syndicate within the meaning of section 1256(e)(3)(B).

(d) *Applicability date.* This section applies to taxable years beginning on or after March 22, 2021. However, taxpayers and their related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), may choose to apply the rules in this section for a taxable year beginning after December 31, 2017, and before March 22, 2021, provided that those taxpayers and their related parties consistently apply all of the rules of this section to that taxable year and each subsequent taxable year.

[T.D. 9943, 86 FR 5540, Jan. 19, 2021]

§ 1.1258–1 Netting rule for certain conversion transactions.

(a) *Purpose.* The purpose of this section is to provide taxpayers with a method to net certain gains and losses from positions of the same conversion transaction before determining the amount of gain treated as ordinary income under section 1258(a).

(b) *Netting of gain and loss for identified transactions*—(1) *In general.* If a taxpayer disposes of or terminates all the positions of an identified netting transaction (as defined in paragraph (b)(2) of this section) within a 14-day period in a single taxable year, all gains and losses on those positions taken into account for Federal tax purposes within that period (other than built-in losses as defined in paragraph (c) of this section) are netted solely for purposes of determining the amount of gain treated as ordinary income under section 1258(a). For purposes of the preceding sentence, a taxpayer is treated as disposing of any position that is treated as sold under any provision of the Code or regulations thereunder (for example, under section 1256(a)(1)).

(2) *Identified netting transaction.* For purposes of this section, an identified netting transaction is a conversion transaction (as defined in section 1258(c)) that the taxpayer identifies as an identified netting transaction on its books and records. Identification of each position of the conversion transaction must be made before the close of the day on which the position becomes part of the conversion transaction. No particular form of identification is necessary, but all the positions of a single conversion transaction must be identified as part of the same transaction and must be distinguished from all other positions.

(c) *Definition of built-in loss.* For purposes of this section, built-in loss means—

(1) Built-in loss as defined in section 1258(d)(3)(B); and

(2) If a taxpayer realizes gain or loss on any one position of a conversion transaction (for example, under section 1256), as of the date that gain or loss is realized, any unrecognized loss in any other position of the conversion transaction that is not disposed of, terminated, or treated as sold under any provision of the Code or regulations thereunder within 14 days of and within the same taxable year as the realization event.

(d) *Examples.* These examples illustrate this section:

Example 1. Identified netting transaction with simultaneous actual dispositions. (i) On December 1, 1995, A purchases 1,000 shares of XYZ stock for $100,000 and enters into a forward contract to sell 1,000 shares of XYZ stock on November 30, 1997, for $110,000. The XYZ stock is actively traded as defined in § 1.1092(d)–1(a) and is a capital asset in A's hands. A maintains books and records on

which, on December 1, 1995, it identifies the two positions as all the positions of a single conversion transaction. A owns no other XYZ stock. On December 1, 1996, when the applicable imputed income amount for the transaction is $7,000, A sells the 1,000 shares of XYZ stock for $95,000. On the same day, A terminates its forward contract with its counterparty, receiving $10,200. No dividends were received on the stock during the time it was part of the conversion transaction.

(ii) The XYZ stock and forward contract are positions of a conversion transaction. Under section 1258(c)(1), substantially all of A's expected return from the overall transaction is attributable to the time value of the net investment in the transaction. Under section 1258(c)(2)(B), the transaction is an applicable straddle as defined in section 1258(d)(1).

(iii) A disposed of or terminated all the positions of the conversion transaction within 14 days and within the same taxable year as required by paragraph (b)(1) of this section. The transaction is an identified netting transaction because it meets the identification requirement of paragraph (b)(2) of this section. Solely for purposes of section 1258(a), the $5,000 loss realized ($100,000 basis less $95,000 amount realized) on the disposition of the XYZ stock is netted against the $10,200 gain recognized on the disposition of the forward contract. Thus, the net gain from the conversion transaction for purposes of section 1258(a) is $5,200 ($10,200 gain less $5,000 loss). Only the $5,200 net gain is recharacterized as ordinary income under section 1258(a) even though the applicable imputed income amount is $7,000. For Federal tax purposes other than section 1258(a), A has recognized a $10,200 gain on the disposition of the forward contract ($5,200 of which is treated as ordinary income) and realized a separate $5,000 loss on the sale of the XYZ stock.

Example 2. Identified netting transaction with built-in loss. (i) The facts are the same as in *Example 1*, except that A had purchased the XYZ stock for $104,000 on May 15, 1995. The XYZ stock had a fair market value of $100,000 on December 1, 1995, the date it became part of a conversion transaction.

(ii) The results are the same as in *Example 1*, except that A has built-in loss (in addition to the $5,000 loss that arose economically during the period of the conversion transaction), as defined in section 1258(d)(3)(B), of $4,000 on the XYZ stock. That $4,000 built-in loss is not netted against the $10,200 gain on the forward contract for purposes of section 1258(a). Thus, the net gain from the conversion transaction for purposes of section 1258(a) is $5,200, the same as in *Example 1*. The $4,000 built-in loss is recognized and has a character determined without regard to section 1258.

(e) *Effective date and transition rule*—(1) *In general.* These regulations are effective for conversion transactions that are outstanding on or after December 21, 1995.

(2) *Transition rule for identification requirements.* In the case of a conversion transaction entered into before February 20, 1996, paragraph (b)(2) of this section is treated as satisfied if the identification is made before the close of business on February 20, 1996.

[T.D. 8649, 60 FR 66084, Dec. 21, 1995]

§ 1.1271–0 Original issue discount; effective date; table of contents.

(a) *Effective date.* Except as otherwise provided, §§ 1.1271–1 through 1.1275–5 apply to debt instruments issued on or after April 4, 1994. Taxpayers, however, may rely on these sections (as contained in 26 CFR part 1 revised April 1, 1996) for debt instruments issued after December 21, 1992, and before April 4, 1994.

(b) *Table of contents.* This section lists captioned paragraphs contained in §§ 1.1271–1 through 1.1275–7.

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(b) Publicly traded debt instruments issued for property.
(1) Issue price.
(2) Issue date.
(c) Debt instruments issued for publicly traded property.
(1) Issue price.
(2) Issue date.
(d) Other debt instruments.
(1) Issue price.
(2) Issue date.
(e) Special rule for certain sales to bond houses, brokers, or similar persons.
(f) Traded on an established market (publicly traded).
(1) In general.
(2) Sales price.
(3) Firm quote.
(4) Indicative quote.
(5) Presumption that price or quote is equal to fair market value.
(6) Exception for small debt issues.
(7) Anti-abuse rules.
(8) Convertible debt instruments.
(9) Issuer-holder consistency requirement.
(10) Effective/applicability dates.
(g) Treatment of certain cash payments incident to lending transactions.
(1) Applicability.
(2) Payments from borrower to lender.
(3) Payments from lender to borrower.
(4) Payments between lender and third party.
(5) Examples.
(h) Investment units.
(1) In general.
(2) Consistent allocation by holders and issuer.
(i) [Reserved]
(j) Convertible debt instruments.
(k) Below-market loans subject to section 7872(b).
(l) [Reserved]
(m) Treatment of amounts representing pre-issuance accrued interest.
(1) Applicability.
(2) Exclusion of pre-issuance accrued interest from issue price.
(3) Example.

§ 1.1274–1 Debt instruments to which section 1274 applies.

(a) In general.
(b) Exceptions.
(1) Debt instrument with adequate stated interest and no OID .
(2) Exceptions under sections 1274(c)(1)(B), 1274(c)(3), 1274A(c), and 1275(b)(1).

(3) Other exceptions to section 1274.
(c) Examples.

§ 1.1274–2 Issue price of debt instruments to which section 1274 applies.

(a) In general.
(b) Issue price.
(1) Debt instruments that provide for adequate stated interest; stated principal amount.
(2) Debt instruments that do not provide for adequate stated interest; imputed principal amount.
(3) Debt instruments issued in a potentially abusive situation; fair market value.
(c) Determination of whether a debt instrument provides for adequate stated interest.
(1) In general.
(2) Determination of present value.
(d) Treatment of certain options.
(e) Mandatory sinking funds.
(f) Treatment of variable rate debt instruments.
(1) Stated interest at a qualified floating rate.
(2) Stated interest at a single objective rate.
(g) Treatment of contingent payment debt instruments.
(h) Examples.
(i) [Reserved]
(j) Special rules for tax-exempt obligations.
(1) Certain variable rate debt instruments.
(2) Contingent payment debt instruments.
(3) Effective date.

§ 1.1274–3 Potentially abusive situations defined.

(a) In general.
(b) Operating rules.
(1) Debt instrument exchanged for nonrecourse financing.
(2) Nonrecourse debt with substantial down payment.
(3) Clearly excessive interest.
(4) Debt-for-debt exchange.
(c) Other situations to be specified by Commissioner.
(d) Consistency rule.

§ 1.1274–4 Test rate.

(a) Determination of test rate of interest.
(1) In general.
(2) Test rate for certain debt instruments.
(b) Applicable Federal rate.
(c) Special rules to determine the term of a debt instrument for purposes of determining the applicable Federal rate.
(1) Installment obligations.
(2) Certain variable rate debt instruments.
(3) Counting of either the issue date or the maturity date.
(4) Certain debt instruments that provide for principal payments uncertain as to time.
(d) Foreign currency loans.
(e) Examples.

§ 1.1274–5 Assumptions.

(a) In general.
(b) Modifications of debt instruments.
(1) In general.
(2) Election to treat buyer as modifying the debt instrument.
(c) Wraparound indebtedness.
(d) Consideration attributable to assumed debt.

§ 1.1274A–1 Special rules for certain transactions where stated principal amount does not exceed $2,800,000.

(a) In general.
(b) Rules for both qualified and cash method debt instruments.
(1) Sale-leaseback transactions.
(2) Debt instruments calling for contingent payments.
(3) Aggregation of transactions.
(4) Inflation adjustment of dollar amounts.
(c) Rules for cash method debt instruments.
(1) Time and manner of making cash method election.
(2) Successors of electing parties.
(3) Modified debt instrument.
(4) Debt incurred or continued to purchase or carry a cash method debt instrument.

§ 1.1275–1 Definitions.

(a) Applicability.
(b) Adjusted issue price.
(1) In general.
(2) Adjusted issue price for subsequent holders.
(c) OID.
(d) Debt instrument.
(e) Tax-exempt obligations.
(f) Issue.
(1) *Debt instruments issued on or after March 13, 2001.*
(2) *Debt instruments issued before March 13, 2001.*
(3) *Transition rule.*
(4) *Cross-references for reopening and aggregation rules.*
(g) Debt instruments issued by a natural person.
(h) Publicly offered debt instrument.
(i) [Reserved]
(j) Life annuity exception under section 1275(a)(1)(B)(i).
(k) Exception under section 1275(a)(1)(B)(ii) for annuities issued by an insurance company subject to tax under subchapter L of the Internal Revenue Code.
(1) Rule.
(2) Examples.
(3) Effective date.
(1) Purpose.
(2) General rule.
(3) Availability of a cash surrender option.
(4) Availability of a loan secured by the contract.
(5) Minimum payout provision.

(6) Maximum payout provision.
(7) Decreasing payout provision.
(8) Effective dates.

§ 1.1275–2 Special rules relating to debt instruments.

(a) Payment ordering rule.
(1) In general.
(2) Exceptions.
(b) Debt instruments distributed by corporations with respect to stock.
(1) Treatment of distribution.
(2) Issue date.
(c) Aggregation of debt instruments.
(1) General rule.
(2) Exception if separate issue price established.
(3) Special rule for debt instruments that provide for the issuance of additional debt instruments.
(4) Examples.
(d) *Special rules for Treasury securities.*
(1) *Issue price and issue date.*
(2) *Reopenings of Treasury securities.*
(e) Disclosure of certain information to holders.
(f) Treatment of pro rata prepayments.
(1) Treatment as retirement of separate debt instrument.
(2) Definition of pro rata prepayment.
(g) Anti-abuse rule.
(1) In general.
(2) Unreasonable result.
(3) Examples.
(4) Effective date.
(h) Remote and incidental contingencies.
(1) In general.
(2) Remote contingencies.
(3) Incidental contingencies.
(4) Aggregation rule.
(5) Consistency rule.
(6) Subsequent adjustments.
(7) Effective date.
(i) [Reserved]
(j) Treatment of certain modifications.
(k) *Reopenings.*
(1) *In general.*
(2) *Definitions.*
(3) *Qualified reopening.*
(4) *Issuer's treatment of a qualified reopening.*
(5) *Effective/applicability dates.*
(l) *OID rule for income item subject to section 451(b).*
(1) In general.
(2) Applicability dates.

§ 1.1275–3 OID information reporting requirements.

(a) In general.
(b) Information required to be set forth on face of debt instruments that are not publicly offered.
(1) In general.
(2) Time for legending.
(3) Legend must survive reissuance upon transfer.
(4) Exceptions.
(c) Information required to be reported to Secretary upon issuance of publicly offered debt instruments.
(1) In general.
(2) Time for filing information return.
(3) Exceptions.
(4) Subsequent registration.
(d) Application to foreign issuers and U.S. issuers of foreigntargeted debt instruments.
(e) Penalties.
(f) Effective date.

§ 1.1275–4 Contingent payment debt instruments.

(a) Applicability.
(1) In general.
(2) Exceptions.
(3) Insolvency and default.
(4) Convertible debt instruments.
(5) Remote and incidental contingencies.
(b) Noncontingent bond method.
(1) Applicability.
(2) In general.
(3) Description of method.
(4) Comparable yield and projected payment schedule.
(5) Qualified stated interest.
(6) Adjustments.
(7) Adjusted issue price, adjusted basis, and retirement.
(8) Character on sale, exchange, or retirement.
(9) Operating rules.
(c) Method for debt instruments not subject to the noncontingent bond method.
(1) Applicability.
(2) Separation into components.
(3) Treatment of noncontingent payments.
(4) Treatment of contingent payments.
(5) Basis different from adjusted issue price.
(6) Treatment of a holder on sale, exchange, or retirement.
(7) Examples.
(d) Rules for tax-exempt obligations.
(1) In general.
(2) Certain tax-exempt obligations with interest-based or revenue-based payments
(3) All other tax-exempt obligations.
(4) Basis different from adjusted issue price.
(e) Amounts treated as interest under this section.
(f) Effective date.

§ 1.1275–5 Variable rate debt instruments.

(a) Applicability.
(1) In general.
(2) Principal payments.
(3) Stated interest.
(4) Current value.
(5) No contingent principal payments.
(6) Special rule for debt instruments issued for nonpublicly traded property.
(b) Qualified floating rate.
(1) In general.

(2) Certain rates based on a qualified floating rate.
(3) Restrictions on the stated rate of interest.
(c) Objective rate.
(1) Definition.
(2) Other objective rates to be specified by Commissioner.
(3) Qualified inverse floating rate.
(4) Significant front-loading or back-loading of interest.
(5) Tax-exempt obligations.
(d) Examples.
(e) Qualified stated interest and OID with respect to a variable rate debt instrument.
(1) In general.
(2) Variable rate debt instrument that provides for annual payments of interest at a single variable rate.
(3) All other variable rate debt instruments except for those that provide for a fixed rate.
(4) Variable rate debt instrument that provides for a single fixed rate.
(f) Special rule for certain reset bonds.

§ 1.1275–6 Integration of qualifying debt instruments.

(a) In general.
(b) Definitions.
(1) Qualifying debt instrument.
(2) Section 1.1275–6 hedge.
(3) Financial instrument.
(4) Synthetic debt instrument.
(c) Integrated transaction.
(1) Integration by taxpayer.
(2) Integration by Commissioner.
(d) Special rules for legging into and legging out of an integrated transaction.
(1) Legging into.
(2) Legging out.
(e) Identification requirements.
(f) Taxation of integrated transactions.
(1) General rule.
(2) Issue date.
(3) Term.
(4) Issue price.
(5) Adjusted issue price.
(6) Qualified stated interest.
(7) Stated redemption price at maturity.
(8) Source of interest income and allocation of expense.
(9) Effectively connected income.
(10) Not a short-term obligation.
(11) Special rules in the event of integration by the Commissioner.
(12) Retention of separate transaction rules for certain purposes.
(13) Coordination with consolidated return rules.
(g) Predecessors and successors.
(h) Examples.
(i) [Reserved]
(j) Effective date.

§ 1.1275–7 Inflation-indexed debt instruments.

(a) Overview.
(b) Applicability.
(1) In general.
(2) Exceptions.
(c) Definitions.
(1) Inflation-indexed debt instrument.
(2) Reference index.
(3) Qualified inflation index.
(4) Inflation-adjusted principal amount.
(5) Minimum guarantee payment.
(d) Coupon bond method.
(1) In general.
(2) Applicability.
(3) Qualified stated interest.
(4) Inflation adjustments.
(5) Example.
(e) Discount bond method.
(1) In general.
(2) No qualified stated interest.
(3) OID.
(4) Example.
(f) Special rules.
(1) Deflation adjustments.
(2) Adjusted basis.
(3) Subsequent holders.
(4) Minimum guarantee.
(5) Temporary unavailability of a qualified inflation index.
(g) TIPS.
(1) Reopenings.
(2) TIPS issued with more than a de minimis amount of premium.
(h) Effective/applicability dates.
(1) In general.
(2) TIPS issued with more than a de minimis amount of premium.

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§ 1.1271–1 Special rules applicable to amounts received on retirement, sale, or exchange of debt instruments.

(a) *Intention to call before maturity*—(1) *In general.* For purposes of section 1271(a)(2), all or a portion of gain realized on a sale or exchange of a debt instrument to which section 1271 applies is treated as interest income if there was an intention to call the debt instrument before maturity. An intention to call a debt instrument before maturity means a written or oral

agreement or understanding not provided for in the debt instrument between the issuer and the original holder of the debt instrument that the issuer will redeem the debt instrument before maturity. In the case of debt instruments that are part of an issue, the agreement or understanding must be between the issuer and the original holders of a substantial amount of the debt instruments in the issue. An intention to call before maturity can exist even if the intention is conditional (e.g., the issuer's decision to call depends on the financial condition of the issuer on the potential call date) or is not legally binding. For purposes of this section, original holder means the first holder (other than an underwriter or dealer that purchased the debt instrument for resale in the ordinary course of its trade or business).

(2) *Exceptions.* In addition to the exceptions provided in sections 1271(a)(2)(B) and 1271(b), section 1271(a)(2) does not apply to—

(i) A debt instrument that is publicly offered (as defined in § 1.1275–1(h));

(ii) A debt instrument to which section 1272(a)(6) applies (relating to certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration); or

(iii) A debt instrument sold pursuant to a private placement memorandum that is distributed to more than ten offerees and that is subject to the sanctions of section 12(2) of the Securities Act of 1933 (15 U.S.C. 771) or the prohibitions of section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j).

(b) *Short-term obligations*—(1) *In general.* Under sections 1271 (a)(3) and (a)(4), all or a portion of the gain realized on the sale or exchange of a short-term government or nongovernment obligation is treated as interest income. Sections 1271 (a)(3) and (a)(4), however, do not apply to any short-term obligation subject to section 1281. See § 1.1272–1(f) for rules to determine if an obligation is a short-term obligation.

(2) *Method of making elections.* Elections to accrue on a constant yield basis under sections 1271 (a)(3)(E) and (a)(4)(D) are made on an obligation-by-obligation basis by reporting the transaction on the basis of daily compounding on the taxpayer's timely filed Federal income tax return for the year of the sale or exchange. These elections are irrevocable.

(3) *Counting conventions.* In computing the ratable share of acquisition discount under section 1271(a)(3) or OID under section 1271(a)(4), any reasonable counting convention may be used (e.g., 30 days per month/360 days per year).

[T.D. 8517, 59 FR 4809, Feb. 2, 1994]

§ 1.1272–1 Current inclusion of OID in income.

(a) *Overview*—(1) *In general.* Under section 1272(a)(1), a holder of a debt instrument includes accrued OID in gross income (as interest), regardless of the holder's regular method of accounting. A holder includes qualified stated interest (as defined in § 1.1273–1(c)) in income under the holder's regular method of accounting. See §§ 1.446–2 and 1.451–1.

(2) *Debt instruments not subject to OID inclusion rules.* Sections 1272(a)(2) and 1272(c) list exceptions to the general inclusion rule of section 1272(a)(1). For purposes of section 1272(a)(2)(E) (relating to certain loans between natural persons), a loan does not include a stripped bond or stripped coupon within the meaning of section 1286(e), and the rule in section 1272(a)(2)(E)(iii), which treats a husband and wife as 1 person, does not apply to loans made between a husband and wife.

(b) *Accrual of OID*—(1) *Constant yield method.* Except as provided in paragraphs (b)(2) and (b)(3) of this section, the amount of OID includible in the income of a holder of a debt instrument for any taxable year is determined using the constant yield method as described under this paragraph (b)(1).

(i) *Step one: Determine the debt instrument's yield to maturity.* The yield to maturity or yield of a debt instrument is the discount rate that, when used in computing the present value of all principal and interest payments to be made under the debt instrument, produces an amount equal to the issue price of the debt instrument. The yield must be constant over the term of the debt instrument and, when expressed as a percentage, must be calculated to

at least two decimal places. See paragraph (c) of this section for rules relating to the yield of certain debt instruments subject to contingencies.

(ii) *Step two: Determine the accrual periods*. An accrual period is an interval of time over which the accrual of OID is measured. Accrual periods may be of any length and may vary in length over the term of the debt instrument, provided that each accrual period is no longer than 1 year and each scheduled payment of principal or interest occurs either on the final day of an accrual period or on the first day of an accrual period. In general, the computation of OID is simplest if accrual periods correspond to the intervals between payment dates provided by the terms of the debt instrument. In computing the length of accrual periods, any reasonable counting convention may be used (e.g., 30 days per month/360 days per year).

(iii) *Step three: Determine the OID allocable to each accrual period*. Except as provided in paragraph (b)(4) of this section, the OID allocable to an accrual period equals the product of the adjusted issue price of the debt instrument (as defined in § 1.1275–1(b)) at the beginning of the accrual period and the yield of the debt instrument, less the amount of any qualified stated interest allocable to the accrual period. In performing this calculation, the yield must be stated appropriately taking into account the length of the particular accrual period. *Example 1* in paragraph (j) of this section provides a formula for converting a yield based upon an accrual period of one length to an equivalent yield based upon an accrual period of a different length.

(iv) *Step four: Determine the daily portions of OID*. The daily portions of OID are determined by allocating to each day in an accrual period the ratable portion of the OID allocable to the accrual period. The holder of the debt instrument includes in income the daily portions of OID for each day during the taxable year on which the holder held the debt instrument.

(2) *Exceptions*. Paragraph (b)(1) of this section does not apply to—

(i) A debt instrument to which section 1272(a)(6) applies (certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration);

(ii) A debt instrument that provides for contingent payments, other than a debt instrument described in paragraph (c) or (d) of this section or except as provided in § 1.1275–4; or

(iii) A variable rate debt instrument to which § 1.1275–5 applies, except as provided in § 1.1275–5.

(3) *Modifications*. The amount of OID includible in income by a holder under paragraph (b)(1) of this section is adjusted if—

(i) The holder purchased the debt instrument at a premium or an acquisition premium (within the meaning of § 1.1272–2); or

(ii) The holder made an election for the debt instrument under § 1.1272–3 to treat all interest as OID.

(4) *Special rules for determining the OID allocable to an accrual period*. The following rules apply to determine the OID allocable to an accrual period under paragraph (b)(1)(iii) of this section.

(i) *Unpaid qualified stated interest allocable to an accrual period*. In determining the OID allocable to an accrual period, if an interval between payments of qualified stated interest contains more than 1 accrual period—

(A) The amount of qualified stated interest payable at the end of the interval (including any qualified stated interest that is payable on the first day of the accrual period immediately following the interval) is allocated on a pro rata basis to each accrual period in the interval; and

(B) The adjusted issue price at the beginning of each accrual period in the interval must be increased by the amount of any qualified stated interest that has accrued prior to the first day of the accrual period but that is not payable until the end of the interval. See *Example 2* of paragraph (j) of this section for an example illustrating the rules in this paragraph (b)(4)(i).

(ii) *Final accrual period*. The OID allocable to the final accrual period is the difference between the amount payable at maturity (other than a payment of qualified stated interest) and the adjusted issue price at the beginning of the final accrual period.

(iii) *Initial short accrual period*. If all accrual periods are of equal length, except for either an initial shorter accrual period or an initial and a final shorter accrual period, the amount of OID allocable to the initial accrual period may be computed using any reasonable method. See *Example 3* in paragraph (j) of this section.

(iv) *Payment on first day of an accrual period*. The adjusted issue price at the beginning of an accrual period is reduced by the amount of any payment (other than a payment of qualified stated interest) that is made on the first day of the accrual period.

(c) *Yield and maturity of certain debt instruments subject to contingencies*—(1) *Applicability*. This paragraph (c) provides rules to determine the yield and maturity of certain debt instruments that provide for an alternative payment schedule (or schedules) applicable upon the occurrence of a contingency (or contingencies). This paragraph (c) applies, however, only if the timing and amounts of the payments that comprise each payment schedule are known as of the issue date and the debt instrument is subject to paragraph (c)(2), (3), or (5) of this section. A debt instrument does not provide for an alternative payment schedule merely because there is a possibility of impairment of a payment (or payments) by insolvency, default, or similar circumstances. See § 1.1275–4 for the treatment of a debt instrument that provides for a contingency that is not described in this paragraph (c). See § 1.1273–1(c) to determine whether stated interest on a debt instrument subject to this paragraph (c) is qualified stated interest.

(2) *Payment schedule that is significantly more likely than not to occur*. If, based on all the facts and circumstances as of the issue date, a single payment schedule for a debt instrument, including the stated payment schedule, is significantly more likely than not to occur, the yield and maturity of the debt instrument are computed based on this payment schedule.

(3) *Mandatory sinking fund provision*. Notwithstanding paragraph (c)(2) of this section, if a debt instrument is subject to a mandatory sinking fund provision, the provision is ignored for purposes of computing the yield and maturity of the debt instrument if the use and terms of the provision meet reasonable commercial standards. For purposes of the preceding sentence, a mandatory sinking fund provision is a provision that meets the following requirements:

(i) The provision requires the issuer to redeem a certain amount of debt instruments in an issue prior to maturity.

(ii) The debt instruments actually redeemed are chosen by lot or purchased by the issuer either in the open market or pursuant to an offer made to all holders (with any proration determined by lot).

(iii) On the issue date, the specific debt instruments that will be redeemed on any date prior to maturity cannot be identified.

(4) *Consistency rule*. [Reserved]

(5) *Treatment of certain options*. Notwithstanding paragraphs (c) (2) and (3) of this section, the rules of this paragraph (c)(5) determine the yield and maturity of a debt instrument that provides the holder or issuer with an unconditional option or options, exercisable on one or more dates during the term of the debt instrument, that, if exercised, require payments to be made on the debt instrument under an alternative payment schedule or schedules (e.g., an option to extend or an option to call a debt instrument at a fixed premium). Under this paragraph (c)(5), an issuer is deemed to exercise or not exercise an option or combination of options in a manner that minimizes the yield on the debt instrument, and a holder is deemed to exercise or not exercise an option or combination of options in a manner that maximizes the yield on the debt instrument. If both the issuer and the holder have options, the rules of this paragraph (c)(5) are applied to the options in the order that they may be exercised. See paragraph (j) *Example 5* through *Example 8* of this section.

(6) *Subsequent adjustments*. If a contingency described in this paragraph (c) (including the exercise of an option described in paragraph (c)(5) of this section) actually occurs or does not occur, contrary to the assumption made pursuant to this paragraph (c) (a

change in circumstances), then, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the change in circumstances for an amount equal to its adjusted issue price on that date. See paragraph (j) *Example 5* and *Example 7* of this section. If, however, the change in circumstances results in a substantially contemporaneous pro-rata prepayment as defined in § 1.1275–2(f)(2), the pro-rata prepayment is treated as a payment in retirement of a portion of the debt instrument, which may result in gain or loss to the holder. See paragraph (j) *Example 6* and *Example 8* of this section.

(7) *Effective date*. This paragraph (c) applies to debt instruments issued on or after August 13, 1996.

(d) *Certain debt instruments that provide for a fixed yield*. If a debt instrument provides for one or more contingent payments but all possible payment schedules under the terms of the instrument result in the same fixed yield, the yield of the debt instrument is the fixed yield. For example, the yield of a debt instrument with principal payments that are fixed in total amount but that are uncertain as to time (such as a demand loan) is the stated interest rate if the issue price of the instrument is equal to the stated principal amount and interest is paid or compounded at a fixed rate over the entire term of the instrument. This paragraph (d) applies to debt instruments issued on or after August 13, 1996.

(e) *Convertible debt instruments*. For purposes of section 1272, an option is ignored if it is an option to convert a debt instrument into the stock of the issuer, into the stock or debt of a related party (within the meaning of section 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt. For debt instruments issued on or after February 5, 2013, the term *stock* in the preceding sentence means an equity interest in any entity that is classified, for Federal tax purposes, as either a partnership or a corporation.

(f) *Special rules to determine whether a debt instrument is a short-term obligation*—(1) *Counting of either the issue date or maturity date*. For purposes of determining whether a debt instrument is a short-term obligation (i.e., a debt instrument with a fixed maturity date that is not more than 1 year from the date of issue), the term of the debt instrument includes either the issue date or the maturity date, but not both dates.

(2) *Coordination with paragraph (c) of this section for certain sections of the Internal Revenue Code*. Notwithstanding paragraph (c) of this section, solely for purposes of determining whether a debt instrument is a short-term obligation under sections 871(g)(1)(B)(i), 881, 1271(a)(3), 1271(a)(4), 1272(a)(2)(C), and 1283(a)(1), the maturity date of a debt instrument is the last possible date that the instrument could be outstanding under the terms of the instrument. For purposes of the preceding sentence, the last possible date that the debt instrument could be outstanding is determined without regard to § 1.1275–2(h) (relating to payments subject to remote or incidental contingencies).

(g) *Basis adjustment*. The basis of a debt instrument in the hands of the holder is increased by the amount of OID included in the holder's gross income and decreased by the amount of any payment from the issuer to the holder under the debt instrument other than a payment of qualified stated interest. See, however, § 1.1275–2(f) for rules regarding basis adjustments on a pro rata prepayment.

(h) *Debt instruments denominated in a currency other than the U.S. dollar*. Section 1272 and this section apply to a debt instrument that provides for all payments denominated in, or determined by reference to, the functional currency of the taxpayer or qualified business unit of the taxpayer (even if that currency is other than the U.S. dollar). See § 1.988–2(b) to determine interest income or expense for debt instruments that provide for payments denominated in, or determined by reference to, a nonfunctional currency.

(i) [Reserved]

(j) *Examples*. The following examples illustrate the rules of this section. Each example assumes that all taxpayers use the calendar year as the taxable year. In addition, each example assumes a 30-day month, 360-day year,

and that the initial accrual period begins on the issue date and the final accrual period ends on the day before the stated maturity date. Although, for purposes of simplicity, the yield as stated is rounded to two decimal places, the computations do not reflect any such rounding convention.

Example 1. Accrual of OID on zero coupon debt instrument; choice of accrual periods. (i) *Facts.* On July 1, 1994, A purchases at original issue, for $675,564.17, a debt instrument that matures on July 1, 1999, and provides for a single payment of $1,000,000 at maturity.

(ii) *Determination of yield.* Under paragraph (b)(1)(i) of this section, the yield of the debt instrument is 8 percent, compounded semiannually.

(iii) *Determination of accrual period.* Under paragraph (b)(1)(ii) of this section, accrual periods may be of any length, provided that each accrual period is no longer than 1 year and each scheduled payment of principal or interest occurs either on the first or final day of an accrual period. The yield to maturity to be used in computing OID accruals in any accrual period, however, must reflect the length of the accrual period chosen. A yield based on compounding b times per year is equivalent to a yield based on compounding c times per year as indicated by the following formula:

$$r = c\{(1 + i/b)^{b/c} - 1\}$$

In which:

i = The yield based on compounding b times per year expressed as a decimal
r = The equivalent yield based on compounding c times per year expressed as a decimal
b = The number of compounding periods in a year on which i is based (for example, 12, if i is based on monthly compounding)
c = The number of compounding periods in a year on which r is based

(iv) *Determination of OID allocable to each accrual period.* Assume that A decides to compute OID on the debt instrument using semiannual accrual periods. Under paragraph (b)(1)(iii) of this section, the OID allocable to the first semiannual accrual period is $27,022.56: the product of the issue price ($675,564.17) and the yield properly adjusted for the length of the accrual period (8 percent/2), less qualified stated interest allocable to the accrual period ($0). The daily portion of OID for the first semiannual accrual period is $150.13 ($27,022.56/180).

(v) *Determination of OID if monthly accrual periods are used.* Alternatively, assume that A decides to compute OID on the debt instrument using monthly accrual periods. Using the above formula, the yield on the debt instrument reflecting monthly compounding is 7.87 percent, compounded monthly ($12\{(1 + .08/2)^{2/12} - 1\}$). Under paragraph (b)(1)(iii) of this section, the OID allocable to the first monthly accrual period is $4,430.48: the product of the issue price ($675,564.17) and the yield properly adjusted for the length of the accrual period (7.87 percent/12), less qualified stated interest allocable to the accrual period ($0). The daily portion of OID for the first monthly accrual period is $147.68 ($4,430.48/30).

Example 2. Accrual of OID on debt instrument with qualified stated interest. (i) *Facts.* On September 1, 1994, A purchases at original issue, for $90,000, B corporation's debt instrument that matures on September 1, 2004, and has a stated principal amount of $100,000, payable on that date. The debt instrument provides for semiannual payments of interest of $3,000, payable on September 1 and March 1 of each year, beginning on March 1, 1995.

(ii) *Determination of yield.* The debt instrument is a 10-year debt instrument with an issue price of $90,000 and a stated redemption price at maturity of $100,000. The semiannual payments of $3,000 are qualified stated interest payments. Under paragraph (b)(1)(i) of this section, the yield is 7.44 percent, compounded semiannually.

(iii) *Accrual of OID if semiannual accrual periods are used.* Assume that A decides to compute OID on the debt instrument using semiannual accrual periods. Under paragraph (b)(1)(iii) of this section, the OID allocable to the first semiannual accrual period equals the product of the issue price ($90,000) and the yield properly adjusted for the length of the accrual period (7.44 percent/2), less qualified stated interest allocable to the accrual period ($3,000). Therefore, the amount of OID for the first semiannual accrual period is $345.78 ($3,345.78–$3,000).

(iv) *Adjustment for accrued but unpaid qualified stated interest if monthly accrual periods are used.* Assume, alternatively, that A decides to compute OID on the debt instrument using monthly accrual periods. The yield, compounded monthly, is 7.32 percent. Under paragraph (b)(1)(iii) of this section, the OID allocable to the first monthly accrual period is the product of the issue price ($90,000) and the yield properly adjusted for the length of the accrual period (7.32 percent/12), less qualified stated interest allocable to the accrual period. Under paragraph (b)(4)(i)(A) of this section, the qualified stated interest allocable to the first monthly accrual period is the pro rata amount of qualified stated interest allocable to the interval between payment dates ($3,000 × ⅙, or $500). Therefore, the amount of OID for the first monthly accrual period is $49.18 ($549.18–$500). Under paragraph (b)(4)(i)(B) of this section, the adjusted issue price of the debt instrument for purposes of determining the amount of OID for the second monthly accrual period is $90,549.18 ($90,000 + $49.18 + $500). Although

the adjusted issue price of the debt instrument for this purpose includes the amount of qualified stated interest allocable to the first monthly accrual period, A includes the qualified stated interest in income based on A's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method).

Example 3. Accrual of OID for debt instrument with initial short accrual period. (i) *Facts.* On May 1, 1994, G purchases at original issue, for $80,000, H corporation's debt instrument maturing on July 1, 2004. The debt instrument provides for a single payment at maturity of $250,000. G computes its OID using 6-month accrual periods ending on January 1 and July 1 of each year and an initial short 2-month accrual period from May 1, 1994, through June 30, 1994.

(ii) *Determination of yield.* The yield on the debt instrument is 11.53 percent, compounded semiannually.

(iii) *Determination of OID allocable to initial short accrual period.* Under paragraph (b)(4)(iii) of this section, G may use any reasonable method to compute OID for the initial short accrual period. One reasonable method is to calculate the amount of OID pursuant to the following formula:

$$OID_{short} = IP \times (i/k) \times f$$

In which:

OID_{short} = The amount of OID allocable to the initial short accrual period

IP = The issue price of the debt instrument

i = The yield to maturity expressed as a decimal

k = The number of accrual periods in a year

f = A fraction whose numerator is the number of days in the initial short accrual period, and whose denominator is the number of days in a full accrual period

(iv) *Amount of OID for the initial short accrual period.* Under this method, the amount of OID for the initial short accrual period is $1,537 ($80,000 × (11.53 percent/2) × (60/180)).

(v) *Alternative method.* Another reasonable method is to calculate the amount of OID for the initial short accrual period using the yield based on bi-monthly compounding, computed pursuant to the formula set forth in *Example 1* of paragraph (j) of this section. Under this method, the amount of OID for the initial short accrual period is $1,508.38 ($80,000 × (11.31 percent/6)).

Example 4. Impermissible accrual of OID using a method other than constant yield method. (i) *Facts.* On July 1, 1994, B purchases at original issue, for $100,000, C corporation's debt instrument that matures on July 1, 1999, and has a stated principal amount of $100,000. The debt instrument provides for a single payment at maturity of $148,024.43. The yield of the debt instrument is 8 percent, compounded semiannually.

(ii) *Determination of yield.* Assume that C uses 6 monthly accrual periods to compute its OID for 1994. The yield must reflect monthly compounding (as determined using the formula described in *Example 1* of paragraph (j) of this section). As a result, the monthly yield of the debt instrument is 7.87 percent, divided by 12. C may not compute its monthly yield for the last 6 months in 1994 by dividing 8 percent by 12.

Example 5. Debt instrument subject to put option. (i) *Facts.* On January 1, 1995, G purchases at original issue, for $70,000, H corporation's debt instrument maturing on January 1, 2010, with a stated principal amount of $100,000, payable at maturity. The debt instrument provides for semiannual payments of interest of $4,000, payable on January 1 and July 1 of each year, beginning on July 1, 1995. The debt instrument gives G an unconditional right to put the bond back to H, exercisable on January 1, 2005, in return for $85,000 (exclusive of the $4,000 of stated interest payable on that date).

(ii) *Determination of yield and maturity.* Yield determined without regard to the put option is 12.47 percent, compounded semiannually. Yield determined by assuming that the put option is exercised (i.e., by using January 1, 2005, as the maturity date and $85,000 as the stated principal amount payable on that date) is 12.56 percent, compounded semiannually. Thus, under paragraph (c)(5) of this section, it is assumed that G will exercise the put option, because exercise of the option would increase the yield of the debt instrument. Thus, for purposes of calculating OID, the debt instrument is assumed to be a 10-year debt instrument with an issue price of $70,000, a stated redemption price at maturity of $85,000, and a yield of 12.56 percent, compounded semiannually.

(iii) *Consequences if put option is, in fact, not exercised.* If the put option is, in fact, not exercised, then, under paragraph (c)(6) of this section, the debt instrument is treated, solely for purposes of sections 1272 and 1273, as if it were reissued on January 1, 2005, for an amount equal to its adjusted issue price on that date, $85,000. The new debt instrument matures on January 1, 2010, with a stated principal amount of $100,000 payable on that date and provides for semiannual payments of interest of $4,000. The yield of the new debt instrument is 12.08 percent, compounded semiannually.

Example 6. Debt instrument subject to partial call option. (i) *Facts.* On January 1, 1995, H purchases at original issue, for $95,000, J corporation's debt instrument that matures on January 1, 2000, and has a stated principal amount of $100,000, payable on that date. The debt instrument provides for semiannual payments of interest of $4,000, payable on January 1 and July 1 of each year, beginning on July 1, 1995. On January 1, 1998, J has an

unconditional right to call 50 percent of the principal amount of the debt instrument for $55,000 (exclusive of the $4,000 of stated interest payable on that date). If the call is exercised, the semiannual payments of interest made after the call date will be reduced to $2,000.

(ii) *Determination of yield and maturity.* Yield determined without regard to the call option is 9.27 percent, compounded semiannually. Yield determined by assuming J exercises its call option is 10.75 percent, compounded semiannually. Thus, under paragraph (c)(5) of this section, it is assumed that J will not exercise the call option because exercise of the option would increase the yield of the debt instrument. Thus, for purposes of calculating OID, the debt instrument is assumed to be a 5-year debt instrument with a single principal payment at maturity of $100,000, and a yield of 9.27 percent, compounded semiannually.

(iii) *Consequences if the call option is, in fact, exercised.* If the call option is, in fact, exercised, then under paragraph (c)(6) of this section, the debt instrument is treated as if the issuer made a pro rata prepayment of $55,000 that is subject to § 1.1275–2(f). Consequently, under § 1.1275–2(f)(1), the instrument is treated as consisting of two debt instruments, one that is retired on the call date and one that remains outstanding after the call date. The adjusted issue price, adjusted basis in the hands of the holder, and accrued OID of the original debt instrument is allocated between the two instruments based on the portion of the original instrument treated as retired. Since each payment remaining to be made after the call date is reduced by one-half, one-half of the adjusted issue price, adjusted basis, and accrued OID is allocated to the debt instrument that is treated as retired. The adjusted issue price of the original debt instrument immediately prior to the call date is $97,725.12, which equals the issue price of the original debt instrument ($95,000) increased by the OID previously includible in gross income ($2,725.12). One-half of this adjusted issue price is allocated to the debt instrument treated as retired, and the other half is allocated to the debt instrument that is treated as remaining outstanding. Thus, the debt instrument treated as remaining outstanding has an adjusted issue price immediately after the call date of $97,725.12/2, or $48,862.56. The yield of this debt instrument continues to be 9.27 percent, compounded semiannually. In addition, the portion of H's adjusted basis allocated to the debt instrument treated as retired is $97,725.12/2 or $48,862.56. Accordingly, under section 1271, H realizes a gain on the deemed retirement equal to $6,137.44 ($55,000 − $48,862.56).

Example 7. Debt instrument issued at par that provides for payment of interest in kind. (i) *Facts.* On January 1, 1995, A purchases at original issue, for $100,000, X corporation's debt instrument maturing on January 1, 2000, at a stated principal amount of $100,000, payable on that date. The debt instrument provides for annual payments of interest of $6,000 on January 1 of each year, beginning on January 1, 1996. The debt instrument gives X the unconditional right to issue, in lieu of the first interest payment, a second debt instrument (PIK instrument) maturing on January 1, 2000, with a stated principal amount of $6,000. The PIK instrument, if issued, would provide for annual payments of interest of $360 on January 1 of each year, beginning on January 1, 1997.

(ii) *Aggregation of PIK instrument with original debt instrument.* Under § 1.1275–2(c)(3), the issuance of the PIK instrument is not considered a payment made on the original debt instrument, and the PIK instrument is aggregated with the original debt instrument. The issue date of the PIK instrument is the same as the original debt instrument.

(iii) *Determination of yield and maturity.* The right to issue the PIK instrument is treated as an option to defer the initial interest payment until maturity. Yield determined without regard to the option is 6 percent, compounded annually, Yield determined by assuming X exercises the option is 6 percent, compounded annually. Thus, under paragraph (c)(5) of this section, it is assumed that X will not exercise the option by issuing the PIK instrument because exercise of the option would not decrease the yield of the debt instrument. For purposes of calculating OID, the debt instrument is assumed to be a 5-year debt instrument with a single principal payment at maturity of $100,000 and ten semiannual interest payments of $6,000, beginning on January 1, 1996. As a result, the debt instrument's yield is 6 percent, compounded annually.

(iv) *Determination of OID.* Under the payment schedule that would result if the option was exercised, none of the interest on the debt instrument would be qualified stated interest. Accordingly, under § 1.1273–1(c)(2), no payments on the debt instrument are qualified stated interest payments. Thus, $6,000 of OID accrues during the first annual accrual period. If the PIK instrument is not issued, $6,000 of OID accrues during each annual accrual period.

(v) *Consequences if the PIK instrument is issued.* Under paragraph (c)(6) of this section, if X issues the PIK instrument on January 1, 1996, the issuance of the PIK instrument is not a payment on the debt instrument. Solely for purposes of sections 1272 and 1273, the debt instrument is deemed reissued on January 1, 1996, for an issue price of $106,000. The recomputed yield is 6 percent, compounded annually. The OID for the first annual accrual period after the deemed reissuance is $6,360. The adjusted issue price of the debt

instrument at the beginning of the next annual accrual period is $106,000 ($106,000 + $6,360 − $6,360). The OID for each of the four remaining annual accrual periods is $6,360.

Example 8. Debt instrument issued at a discount that provides for payment of interest in kind. (i) *Facts.* On January 1, 1995, T purchases at original issue, for $75,500, U corporation's debt instrument maturing on January 1, 2000, at a stated principal amount of $100,000, payable on that date. The debt instrument provides for annual payments of interest of $4,000 on January 1 of each year, beginning on January 1, 1996. The debt instrument gives U the unconditional right to issue, in lieu of the first interest payment, a second debt instrument (PIK instrument) maturing on January 1, 2000, with a stated principal amount of $4,000. The PIK instrument, if issued, would provide for annual payments of interest of $160 on January 1 of each year, beginning on January 1, 1997.

(ii) *Aggregation of PIK instrument with original debt instrument.* Under § 1.1275–2(c)(3), the issuance of the PIK instrument is not considered a payment made on the original debt instrument, and the PIK instrument is aggregated with the original debt instrument. The issue date of the PIK instrument is the same as the original debt instrument.

(iii) *Determination of yield and maturity.* The right to issue the PIK instrument is treated as an option to defer the initial interest payment until maturity. Yield determined without regard to the option is 10.55 percent, compounded annually. Yield determined by assuming U exercises the option is 10.32 percent, compounded annually. Thus, under paragraph (c)(5) of this section, it is assumed that U will exercise the option by issuing the PIK instrument because exercise of the option would decrease the yield of the debt instrument. For purposes of calculating OID, the debt instrument is assumed to be a 5-year debt instrument with a single principal payment at maturity of $104,000 and four annual interest payments of $4,160, beginning on January 1, 1997. As a result, the yield is 10.32 percent, compounded annually.

(iv) *Consequences if the PIK instrument is not issued.* Assume that T chooses to compute OID accruals on the basis of an annual accrual period. On January 1, 1996, the adjusted issue price of the debt instrument, and T's adjusted basis in the instrument, is $83,295.15. Under paragraph (c)(6) of this section, if U actually makes the $4,000 interest payment on January 1, 1996, the debt instrument is treated as if U made a pro rata prepayment (within the meaning of § 1.1275–2(f)(2)) of $4,000, which reduces the amount of each payment remaining on the instrument by a factor of 4/104, or 1/26. Thus, under § 1.1275–2(f)(1) and section 1271, T realizes a gain of $796.34 ($4,000 − ($83,295.15/26)). The adjusted issue price of the debt instrument and T's adjusted basis immediately after the payment is $80,091.49 ($83,295.15 × 25/26) and the yield continues to be 10.32 percent, compounded annually.

Example 9. Debt instrument with stepped interest rate. (i) *Facts.* On July 1, 1994, G purchases at original issue, for $85,000, H corporation's debt instrument maturing on July 1, 2004. The debt instrument has a stated principal amount of $100,000, payable on the maturity date and provides for semiannual interest payments on January 1 and July 1 of each year, beginning on January 1, 1995. The amount of each payment is $2,000 for the first 5 years and $5,000 for the final 5 years.

(ii) *Determination of OID.* Assume that G computes its OID using 6-month accrual periods ending on January 1 and July 1 of each year. The yield of the debt instrument, determined under paragraph (b)(1)(i) of this section, is 8.65 percent, compounded semiannually. Interest is unconditionally payable at a fixed rate of at least 4 percent, compounded semiannually, for the entire term of the debt instrument. Consequently, under § 1.1273–1(c)(1), the semiannual payments are qualified stated interest payments to the extent of $2,000. The amount of OID for the first 6-month accrual period is $1,674.34 (the issue price of the debt instrument ($85,000) times the yield of the debt instrument for that accrual period (.0865/2) less the amount of any qualified stated interest allocable to that accrual period ($2,000)).

Example 10. Debt instrument payable on demand that provides for interest at a constant rate. (i) *Facts.* On January 1, 1995, V purchases at original issue, for $100,000, W corporation's debt instrument. The debt instrument calls for interest to accrue at a rate of 9 percent, compounded annually. The debt instrument is redeemable at any time at the option of V for an amount equal to $100,000, plus accrued interest. V uses annual accrual periods to accrue OID on the debt instrument.

(ii) *Amount of OID.* Pursuant to paragraph (d) of this section, the yield of the debt instrument is 9 percent, compounded annually. If the debt instrument is not redeemed during 1995, the amount of OID allocable to the year is $9,000.

[T.D. 8517, 59 FR 4810, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30140, June 14, 1996; T.D. 9612, 78 FR 8015, Feb. 5, 2013]

§ 1.1272–2 Treatment of debt instruments purchased at a premium.

(a) *In general.* Under section 1272(c)(1), if a holder purchases a debt instrument at a premium, the holder does not include any OID in gross income. Under section 1272(a)(7), if a holder purchases a debt instrument at an acquisition premium, the holder reduces the amount of OID includible in

gross income by the fraction determined under paragraph (b)(4) of this section.

(b) *Definitions and special rules*—(1) *Purchase*. For purposes of section 1272 and this section, purchase means any acquisition of a debt instrument, including the acquisition of a newly issued debt instrument in a debt-for-debt exchange or the acquisition of a debt instrument from a donor.

(2) *Premium*. A debt instrument is purchased at a premium if its adjusted basis, immediately after its purchase by the holder (including a purchase at original issue), exceeds the sum of all amounts payable on the instrument after the purchase date other than payments of qualified stated interest (as defined in § 1.1273–1(c)).

(3) *Acquisition premium*. A debt instrument is purchased at an acquisition premium if its adjusted basis, immediately after its purchase (including a purchase at original issue), is—

(i) Less than or equal to the sum of all amounts payable on the instrument after the purchase date other than payments of qualified stated interest (as defined in § 1.1273–1(c)); and

(ii) Greater than the instrument's adjusted issue price (as defined in § 1.1275–1(b)).

(4) *Acquisition premium fraction*. In applying section 1272(a)(7), the cost of a debt instrument is its adjusted basis immediately after its acquisition by the purchaser. Thus, the numerator of the fraction determined under section 1272(a)(7)(B) is the excess of the adjusted basis of the debt instrument immediately after its acquisition by the purchaser over the adjusted issue price of the debt instrument. The denominator of the fraction determined under section 1272(a)(7)(B) is the excess of the sum of all amounts payable on the debt instrument after the purchase date, other than payments of qualified stated interest, over the instrument's adjusted issue price.

(5) *Election to accrue discount on a constant yield basis*. Rather than applying the acquisition premium fraction, a holder of a debt instrument purchased at an acquisition premium may elect under § 1.1272–3 to compute OID accruals by treating the purchase as a purchase at original issuance and applying the mechanics of the constant yield method.

(6) *Special rules for determining basis*—(i) *Debt instruments acquired in exchange for other property*. For purposes of section 1272(a)(7), section 1272(c)(1), and this section, if a debt instrument is acquired in an exchange for other property (other than in a reorganization defined in section 368) and the basis of the debt instrument is determined, in whole or in part, by reference to the basis of the other property, the basis of the debt instrument may not exceed its fair market value immediately after the exchange. For example, if a debt instrument is distributed by a partnership to a partner in a liquidating distribution and the partner's basis in the debt instrument would otherwise be determined under section 732, the partner's basis in the debt instrument may not exceed its fair market value for purposes of this section.

(ii) *Acquisition by gift*. For purposes of this section, a donee's adjusted basis in a debt instrument is the donee's basis for determining gain under section 1015(a).

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

Example 1. Debt instrument purchased at an acquisition premium. (i) *Facts*. On July 1, 1994, A purchased at original issue, for $500, a debt instrument issued by Corporation X. The debt instrument matures on July 1, 1999, and calls for a single payment at maturity of $1,000. Under section 1273(a), the debt instrument has a stated redemption price at maturity of $1,000 and, thus, OID of $500. On July 1, 1996, when the debt instrument's adjusted issue price is $659.75, A sells the debt instrument to B for $750 in cash.

(ii) *Acquisition premium fraction*. Because the cost to B of the debt instrument is less than the amount payable on the debt instrument after the purchase date, but is greater than the debt instrument's adjusted issue price, B has paid an acquisition premium for the debt instrument. Accordingly, the daily portion of OID for any day that B holds the debt instrument is reduced by a fraction, the numerator of which is $90.25 (the excess of the cost of the debt instrument over its adjusted issue price) and the denominator of which is $340.25 (the excess of the sum of all payments after the purchase date over its adjusted issue price).

Example 2. Debt-for-debt exchange where holder is considered to purchase new debt instrument at a premium. (i) *Facts*. On January 1, 1995, H purchases at original issue, for

$1,000, a debt instrument issued by Corporation X. On July 1, 1997, when H's adjusted basis in the debt instrument is $1,000, Corporation X issues a new debt instrument with a stated redemption price at maturity of $750 to H in exchange for the old debt instrument. Assume that the issue price of the new debt instrument is $600. Thus, under section 1273(a), the debt instrument has OID of $150. The exchange qualifies as a recapitalization under section 368(a)(1)(E), with the consequence that, under sections 354 and 358, H recognizes no loss on the exchange and has an adjusted basis in the new debt instrument of $1,000.

(ii) *Application of section 1272(c)(1).* Under paragraphs (b)(1) and (b)(2) of this section, H purchases the new debt instrument at a premium of $250. Accordingly, under section 1272(c)(1), H is not required to include OID in income with respect to the new debt instrument.

Example 3. Debt-for-debt exchange where holder is considered to purchase new debt instrument at an acquisition premium. (i) *Facts.* The facts are the same as in *Example 2* of paragraph (c) of this section, except that H purchases the old debt instrument from another holder on July 1, 1995, and on July 1, 1997, H's adjusted basis in the old debt instrument is $700. Under section 1273(a), the new debt instrument is issued with OID of $150.

(ii) *Application of section 1272(a)(7).* Under paragraphs (b)(1) and (b)(3) of this section, H purchases the new debt instrument at an acquisition premium of $100. Accordingly, the daily portion of OID that is includible in H's income is reduced by the fraction determined under section 1272(a)(7).

Example 4. Treatment of acquisition premium for debt instrument acquired by gift. (i) *Facts.* On July 1, 1994, D receives as a gift a debt instrument with a stated redemption price at maturity of $1,000 and an adjusted issue price of $800. On that date, the fair market value of the debt instrument is $900 and the donor's adjusted basis in the debt instrument is $950.

(ii) *Application of section 1272(a)(7).* Under paragraphs (b)(1), (b)(3), and (b)(6)(ii) of this section, D is considered to have purchased the debt instrument at an acquisition premium of $150. Accordingly, the daily portion of OID that is includible in D's income is reduced by the fraction determined under section 1272(a)(7).

[T.D. 8517, 59 FR 4814, Feb. 2, 1994]

§ 1.1272–3 Election by a holder to treat all interest on a debt instrument as OID.

(a) *Election.* A holder of a debt instrument may elect to include in gross income all interest that accrues on the instrument by using the constant yield method described in paragraph (c) of this section. For purposes of this election, interest includes stated interest, acquisition discount, OID, de minimis OID, market discount, de minimis market discount, and unstated interest, as adjusted by any amortizable bond premium or acquisition premium.

(b) *Scope of election*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, a holder may make the election for any debt instrument.

(2) *Exceptions, limitations, and special rules*—(i) *Debt instrument with amortizable bond premium (as determined under section 171).* (A) A holder may make the election for a debt instrument with amortizable bond premium only if the instrument qualifies as a bond under section 171(d).

(B) If a holder makes the election under this section for a debt instrument with amortizable bond premium, the holder is deemed to have made the election under section 171(c)(2) for the taxable year in which the instrument was acquired. If the holder has previously made the election under section 171(c)(2), the requirements of that election with respect to any debt instrument are satisfied by electing to amortize the bond premium under the rules provided by this section.

(ii) *Debt instrument with market discount.* (A) A holder may make the election under this section for a debt instrument with market discount only if the holder is eligible to make an election under section 1278(b).

(B) If a holder makes the election under this section for a debt instrument with market discount, the holder is deemed to have made both the election under section 1276(b)(2) for that instrument and the election under section 1278(b) for the taxable year in which the instrument was acquired. If the holder has previously made the election under section 1278(b), the requirements of that election with respect to any debt instrument are satisfied by electing to include the market discount in income in accordance with the rules provided by this section.

(iii) *Tax-exempt debt instrument.* A holder may not make the election for a tax-exempt obligation as defined in section 1275(a)(3).

(c) *Mechanics of the constant yield method*—(1) *In general*. For purposes of this section, the amount of interest that accrues during an accrual period is determined under rules similar to those under section 1272 (the constant yield method). In applying the constant yield method, however, a debt instrument subject to the election is treated as if—

(i) The instrument is issued for the holder's adjusted basis immediately after its acquisition by the holder;

(ii) The instrument is issued on the holder's acquisition date; and

(iii) None of the interest payments provided for in the instrument are qualified stated interest payments.

(2) *Special rules to determine adjusted basis*. For purposes of paragraph (c)(1)(i) of this section—

(i) If the debt instrument is acquired in an exchange for other property (other than in a reorganization defined in section 368) and the basis of the debt instrument is determined, in whole or in part, by reference to the basis of the other property, the adjusted basis of the debt instrument may not exceed its fair market value immediately after the exchange; and

(ii) If the debt instrument was acquired with amortizable bond premium (as determined under section 171), the adjusted basis of the debt instrument is reduced by an amount equal to the value attributable to any conversion feature.

(d) *Time and manner of making the election*. The election must be made for the taxable year in which the holder acquires the debt instrument. A holder makes the election by attaching to the holder's timely filed Federal income tax return a statement that the holder is making an election under this section and that identifies the debt instruments subject to the election. A holder may make the election for a class or group of debt instruments by attaching a statement describing the type or types of debt instruments being designated for the election.

(e) *Revocation of election*. The election may not be revoked unless approved by the Commissioner.

(f) *Effective date*. This section applies to debt instruments acquired on or after April 4, 1994.

[T.D. 8517, 59 FR 4815, Feb. 2, 1994]

§ 1.1273–1 Definition of OID.

(a) *In general*. Section 1273(a)(1) defines OID as the excess of a debt instrument's stated redemption price at maturity over its issue price. Section 1.1273–2 defines issue price, and paragraph (b) of this section defines stated redemption price at maturity. Paragraph (d) of this section provides rules for de minimis amounts of OID. Although the total amount of OID for a debt instrument may be indeterminate, § 1.1272–1(d) provides a rule to determine OID accruals on certain debt instruments that provide for a fixed yield. See *Example 10* in § 1.1272–1(j).

(b) *Stated redemption price at maturity*. A debt instrument's stated redemption price at maturity is the sum of all payments provided by the debt instrument other than qualified stated interest payments. If the payment schedule of a debt instrument is determined under § 1.1272–1(c) (relating to certain debt instruments subject to contingencies), that payment schedule is used to determine the instrument's stated redemption price at maturity.

(c) *Qualified stated interest*—(1) *Definition*—(i) *In general*. Qualified stated interest is stated interest that is unconditionally payable in cash or in property (other than debt instruments of the issuer), or that will be constructively received under section 451, at least annually at a single fixed rate (within the meaning of paragraph (c)(1)(iii) of this section).

(ii) *Unconditionally payable*. Interest is unconditionally payable only if reasonable legal remedies exist to compel timely payment or the debt instrument otherwise provides terms and conditions that make the likelihood of late payment (other than a late payment that occurs within a reasonable grace period) or nonpayment a remote contingency (within the meaning of § 1.1275–2(h)). For purposes of the preceding sentence, remedies or other terms and conditions are not taken into account if the lending transaction does not reflect arm's length dealing

and the holder does not intend to enforce the remedies or other terms and conditions. For purposes of determining whether interest is unconditionally payable, the possibility of nonpayment due to default, insolvency, or similar circumstances, or due to the exercise of a conversion option described in § 1.1272–1(e) is ignored. This paragraph (c)(1)(ii) applies to debt instruments issued on or after August 13, 1996.

(iii) *Single fixed rate*—(A) *In general.* Interest is payable at a single fixed rate only if the rate appropriately takes into account the length of the interval between payments. Thus, if the interval between payments varies during the term of the debt instrument, the value of the fixed rate on which a payment is based generally must be adjusted to reflect a compounding assumption that is consistent with the length of the interval preceding the payment. See *Example 1* in paragraph (f) of this section.

(B) *Special rule for certain first and final payment intervals.* Notwithstanding paragraph (c)(1)(iii)(A) of this section, if a debt instrument provides for payment intervals that are equal in length throughout the term of the instrument, except that the first or final payment interval differs in length from the other payment intervals, the first or final interest payment is considered to be made at a fixed rate if the value of the rate on which the payment is based is adjusted in any reasonable manner to take into account the length of the interval. See *Example 2* of paragraph (f) of this section. The rule in this paragraph (c)(1)(iii)(B) also applies if the lengths of both the first and final payment intervals differ from the length of the other payment intervals.

(2) *Debt instruments subject to contingencies.* The determination of whether a debt instrument described in § 1.1272–1(c) (a debt instrument providing for an alternative payment schedule (or schedules) upon the occurrence of one or more contingencies) provides for qualified stated interest is made by analyzing each alternative payment schedule (including the stated payment schedule) as if it were the debt instrument's sole payment schedule. Under this analysis, the debt instrument provides for qualified stated interest to the extent of the lowest fixed rate at which qualified stated interest would be payable under any payment schedule. See *Example (4)* of paragraph (f) of this section.

(3) *Variable rate debt instrument.* In the case of a variable rate debt instrument, qualified stated interest is determined under § 1.1275–5(e).

(4) *Stated interest in excess of qualified stated interest.* To the extent that stated interest payable under a debt instrument exceeds qualified stated interest, the excess is included in the debt instrument's stated redemption price at maturity.

(5) *Short-term obligations.* In the case of a debt instrument with a term that is not more than 1 year from the date of issue, no payments of interest are treated as qualified stated interest payments.

(6) *Business day convention*—(i) *Rule.* For purposes of this paragraph (c), if a scheduled payment date for stated interest falls on a Saturday, Sunday, or Federal holiday (within the meaning of 5 U.S.C. 6103) but, under the terms of the debt instrument, the stated interest is payable on the first business day that immediately follows the scheduled payment date, the stated interest is treated as payable on the scheduled payment date, provided no additional interest is payable as a result of the deferral.

(ii) *Effective/applicability date.* Paragraph (c)(6)(i) of this section applies to a debt instrument issued on or after September 13, 2012. A taxpayer, however, may rely on paragraph (c)(6)(i) of this section for a debt instrument issued before that date.

(d) *De minimis OID*—(1) *In general.* If the amount of OID with respect to a debt instrument is less than the de minimis amount, the amount of OID is treated as zero, and all stated interest (including stated interest that would otherwise be characterized as OID) is treated as qualified stated interest.

(2) *De minimis amount.* The de minimis amount is an amount equal to 0.0025 multiplied by the product of the stated redemption price at maturity and the number of complete years to maturity from the issue date.

(3) *Installment obligations.* In the case of an installment obligation (as defined in paragraph (e)(1) of this section), paragraph (d)(2) of this section is applied by substituting for the number of complete years to maturity the weighted average maturity (as defined in paragraph (e)(3) of this section). Alternatively, in the case of a debt instrument that provides for payments of principal no more rapidly than a self-amortizing installment obligation (as defined in paragraph (e)(2) of this section), the de minimis amount defined in paragraph (d)(2) of this section may be calculated by substituting 0.00167 for 0.0025.

(4) *Special rule for interest holidays, teaser rates, and other interest shortfalls*—(i) *In general.* This paragraph (d)(4) provides a special rule to determine whether a debt instrument with a teaser rate (or rates), an interest holiday, or any other interest shortfall has de minimis OID. This rule applies if—

(A) The amount of OID on the debt instrument is more than the de minimis amount as otherwise determined under paragraph (d) of this section; and

(B) All stated interest provided for in the debt instrument would be qualified stated interest under paragraph (c) of this section except that for 1 or more accrual periods the interest rate is below the rate applicable for the remainder of the instrument's term (e.g., if as a result of an interest holiday, none of the stated interest is qualified stated interest).

(ii) *Redetermination of OID for purposes of the de minimis test.* For purposes of determining whether a debt instrument described in paragraph (d)(4)(i) of this section has de minimis OID, the instrument's stated redemption price at maturity is treated as equal to the instrument's issue price plus the greater of the amount of foregone interest or the excess (if any) of the instrument's stated principal amount over its issue price. The amount of foregone interest is the amount of additional stated interest that would be required to be payable on the debt instrument during the period of the teaser rate, holiday, or shortfall so that all stated interest would be qualified stated interest under paragraph (c) of this section. See *Example 5* and *Example 6* of paragraph (f) of this section. In addition, for purposes of computing the de minimis amount of OID, the weighted average maturity of the debt instrument is determined by treating all stated interest payments as qualified stated interest payments.

(5) *Treatment of de minimis OID by holders*—(i) *Allocation of de minimis OID to principal payments.* The holder of a debt instrument includes any de minimis OID (other than de minimis OID treated as qualified stated interest under paragraph (d)(1) of this section, such as de minimis OID attributable to a teaser rate or interest holiday) in income as stated principal payments are made. The amount includible in income with respect to each principal payment equals the product of the total amount of de minimis OID on the debt instrument and a fraction, the numerator of which is the amount of the principal payment made and the denominator of which is the stated principal amount of the instrument.

(ii) *Character of de minimis OID*—(A) *De minimis OID treated as gain recognized on retirement.* Any amount of de minimis OID includible in income under this paragraph (d)(5) is treated as gain recognized on retirement of the debt instrument. See section 1271 to determine whether a retirement is treated as an exchange of the debt instrument.

(B) *Treatment of de minimis OID on sale or exchange.* Any gain attributable to de minimis OID that is recognized on the sale or exchange of a debt instrument is capital gain if the debt instrument is a capital asset in the hands of the seller.

(iii) *Treatment of subsequent holders.* If a subsequent holder purchases a debt instrument issued with de minimis OID at a premium (as defined in §1.1272–2(b)(2)), the subsequent holder does not include the de minimis OID in income. Otherwise, a subsequent holder includes any discount in income under the market discount rules (sections 1276 through 1278) rather than under the rules of this paragraph (d)(5).

(iv) *Cross-reference.* See §1.1272–3 for an election by a holder to treat de minimis OID as OID.

(e) *Definitions*—(1) *Installment obligation.* An installment obligation is a

debt instrument that provides for the payment of any amount other than qualified stated interest before maturity.

(2) *Self-amortizing installment obligation*. A self-amortizing installment obligation is an obligation that provides for equal payments composed of principal and qualified stated interest that are unconditionally payable at least annually during the entire term of the debt instrument with no significant additional payment required at maturity.

(3) *Weighted average maturity*. The weighted average maturity of a debt instrument is the sum of the following amounts determined for each payment under the instrument (other than a payment of qualified stated interest)—

(i) The number of complete years from the issue date until the payment is made; multiplied by

(ii) A fraction, the numerator of which is the amount of the payment and the denominator of which is the debt instrument's stated redemption price at maturity.

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

Example 1. Qualified stated interest. (i) *Facts*. On January 1, 1995, A purchases at original issue, for $100,000, a debt instrument that matures on January 1, 1999, and has a stated principal amount of $100,000, payable at maturity. The debt instrument provides for interest payments of $8,000 on January 1, 1996, and January 1, 1997, and quarterly interest payments of $1,942.65, beginning on April 1, 1997.

(ii) *Amount of qualified stated interest*. The annual payments of $8,000 and the quarterly payments of $1,942.65 are payable at a single fixed rate because 8 percent, compounded annually, is equivalent to 7.77 percent, compounded quarterly. Consequently, all stated interest payments under the debt instrument are qualified stated interest payments.

Example 2. Qualified stated interest with short initial payment interval. On October 1, 1994, A purchases at original issue, for $100,000, a debt instrument that matures on January 1, 1998, and has a stated principal amount of $100,000, payable at maturity. The debt instrument provides for an interest payment of $2,000 on January 1, 1995, and interest payments of $8,000 on January 1, 1996, January 1, 1997, and January 1, 1998. Under paragraph (c)(1)(iii)(B) of this section, all stated interest payments on the debt instrument are computed at a single fixed rate and are qualified stated interest payments.

Example 3. Stated interest in excess of qualified stated interest. (i) *Facts*. On January 1, 1995, B purchases at original issue, for $100,000, C corporation's 5-year debt instrument. The debt instrument provides for a principal payment of $100,000, payable at maturity, and calls for annual interest payments of $10,000 for the first 3 years and annual interest payments of $10,600 for the last 2 years.

(ii) *Payments in excess of qualified stated interest*. All of the first three interest payments and $10,000 of each of the last two interest payments are qualified stated interest payments within the meaning of paragraph (c)(1) of this section. Under paragraph (c)(4) of this section, the remaining $600 of each of the last two interest payments is included in the stated redemption price at maturity, so that the stated redemption price at maturity is $101,200. Pursuant to paragraph (e)(3) of this section, the weighted average maturity of the debt instrument is 4.994 years [(4 years × $600/$101,200) + (5 years × $100,600/$101,200)]. The de minimis amount, or one-fourth of 1 percent of the stated redemption price at maturity multiplied by the weighted average maturity, is $1,263.50. Because the actual amount of discount, $1,200, is less than the de minimis amount, the instrument is treated as having no OID, and, under paragraph (d)(1) of this section, all of the interest payments are treated as qualified stated interest payments.

Example 4. Qualified stated interest on a debt instrument that is subject to an option. (i) *Facts*. On January 1, 1997, A issues, for $100,000, a 10-year debt instrument that provides for a $100,000 principal payment at maturity and for annual interest payments of $10,000. Under the terms of the debt instrument, A has the option, exercisable on January 1, 2002, to lower the annual interest payments to $8,000. In addition, the debt instrument gives the holder an unconditional right to put the debt instrument back to A, exercisable on January 1, 2002, in return for $100,000.

(ii) *Amount of qualified stated interest*. Under paragraph (c)(2) of this section, the debt instrument provides for qualified stated interest to the extent of the lowest fixed rate at which qualified stated interest would be payable under any payment schedule. If the payment schedule determined by assuming that the issuer's option will be exercised and the put option will not be exercised were treated as the debt instrument's sole payment schedule, only $8,000 of each annual interest payment would be qualified stated interest. Under any other payment schedule, the debt instrument would provide for annual qualified stated interest payments of $10,000. Accordingly, only $8,000 of each annual interest payment is qualified stated interest. Any excess of each annual interest payment over $8,000 is included in the debt instrument's stated redemption price at maturity.

Example 5. De minimis OID; interest holiday. (i) *Facts.* On January 1, 1995, C purchases at original issue, for $97,561, a debt instrument that matures on January 1, 2007, and has a stated principal amount of $100,000, payable at maturity. The debt instrument provides for an initial interest holiday of 1 quarter and quarterly interest payments of $2,500 thereafter (beginning on July 1, 1995). The issue price of the debt instrument is $97,561. C chooses to accrue OID based on quarterly accrual periods.

(ii) *De minimis amount of OID.* But for the interest holiday, all stated interest on the debt instrument would be qualified stated interest. Under paragraph (d)(4) of this section, for purposes of determining whether the debt instrument has de minimis OID, the stated redemption price at maturity of the instrument is $100,061 ($97,561 (issue price) plus $2,500 (the greater of the amount of foregone interest ($2,500) and the amount equal to the excess of the instrument's stated principal amount over its issue price ($2,439)). Thus, the debt instrument is treated as having OID of $2,500 ($100,061 minus $97,561). Because this amount is less than the de minimis amount of $3,001.83 (0.0025 multiplied by $100,061 multiplied by 12 complete years to maturity), the debt instrument is treated as having no OID, and all stated interest is treated as qualified stated interest.

Example 6. De minimis OID; teaser rate. (i) *Facts.* The facts are the same as in *Example 5* of this paragraph (f) except that C uses an initial semiannual accrual period rather than an initial quarterly accrual period.

(ii) *De minimis amount of OID.* The debt instrument provides for an initial teaser rate because the interest rate for the semiannual accrual period is less than the interest rate applicable to the subsequent quarterly accrual periods. But for the initial teaser rate, all stated interest on the debt instrument would be qualified stated interest. Under paragraph (d)(4) of this section, for purposes of determining whether the debt instrument has de minimis OID, the stated redemption price at maturity of the instrument is $100,123.50 ($97,561 (issue price) plus $2,562.50 (the greater of the amount of foregone interest ($2,562.50) and the amount equal to the excess of the instrument's stated principal amount over its issue price ($2,439)). Thus, the debt instrument is treated as having OID of $2,562.50 ($100,123.50 minus $97,561). Because this amount is less than the de minimis amount of $3,003.71 (0.0025 multiplied by $100,123.50 multiplied by 12 complete years to maturity), the debt instrument is treated as having no OID, and all stated interest is treated as qualified stated interest.

[T.D. 8517, 59 FR 4815, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30141, June 14, 1996; T.D. 9599, 77 FR 56536, Sept. 13, 2012]

§ 1.1273–2 Determination of issue price and issue date.

(a) *Debt instruments issued for money*—(1) *Issue price.* If a substantial amount of the debt instruments in an issue is issued for money, the issue price of each debt instrument in the issue is the first price at which a substantial amount of the debt instruments is sold for money. Thus, if an issue consists of a single debt instrument that is issued for money, the issue price of the debt instrument is the amount paid for the instrument. For example, in the case of a debt instrument evidencing a loan to a natural person, the issue price of the instrument is the amount loaned. See § 1.1275–2(d) for rules regarding Treasury securities. For purposes of this paragraph (a), money includes functional currency and, in certain circumstances, nonfunctional currency. See § 1.988–2(b)(2) for circumstances when nonfunctional currency is treated as money rather than as property.

(2) *Issue date.* The issue date of an issue described in paragraph (a)(1) of this section is the first settlement date or closing date, whichever is applicable, on which a substantial amount of the debt instruments in the issue is sold for money.

(b) *Publicly traded debt instruments issued for property*—(1) *Issue price.* If a substantial amount of the debt instruments in an issue is traded on an established market (within the meaning of paragraph (f) of this section) and the issue is not described in paragraph (a)(1) of this section, the issue price of each debt instrument in the issue is the fair market value of the debt instrument, determined as of the issue date (as defined in paragraph (b)(2) of this section). See paragraph (f) of this section for rules to determine the fair market value of a debt instrument for purposes of this section.

(2) *Issue date.* The issue date of an issue described in paragraph (b)(1) of this section is the first date on which a substantial amount of the traded debt instruments in the issue is issued.

(c) *Debt instruments issued for publicly traded property*—(1) *Issue price.* If a substantial amount of the debt instruments in an issue is issued for property that is traded on an established market (within the meaning of paragraph (f) of

this section) and the issue is not described in paragraph (a)(1) or (b)(1) of this section, the issue price of each debt instrument in the issue is the fair market value of the property, determined as of the issue date (as defined in paragraph (c)(2) of this section). For purposes of the preceding sentence, property means a debt instrument, stock, security, contract, commodity, or nonfunctional currency. But see §1.988–2(b)(2) for circumstances when nonfunctional currency is treated as money rather than as property. See paragraph (f) of this section for rules to determine the fair market value of property for purposes of this section.

(2) *Issue date.* The issue date of an issue described in paragraph (c)(1) of this section is the first date on which a substantial amount of the debt instruments in the issue is issued for traded property.

(d) *Other debt instruments*—(1) *Issue price.* If an issue of debt instruments is not described in paragraph (a)(1), (b)(1), or (c)(1) of this section, the issue price of each debt instrument in the issue is determined as if the debt instrument were a separate issue. If the issue price of a debt instrument that is treated as a separate issue under the preceding sentence is not determined under paragraph (a)(1), (b)(1), or (c)(1) of this section, and if section 1274 applies to the debt instrument, the issue price of the instrument is determined under section 1274. Otherwise, the issue price of the debt instrument is its stated redemption price at maturity under section 1273(b)(4). See section 1274(c) and §1.1274–1 to determine if section 1274 applies to a debt instrument.

(2) *Issue date.* The issue date of an issue described in paragraph (d)(1) of this section is the date on which the debt instrument is issued for money or in a sale or exchange.

(e) *Special rule for certain sales to bond houses, brokers, or similar persons.* For purposes of determining the issue price and issue date of a debt instrument under this section, sales to bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters, placement agents, or wholesalers are ignored.

(f) *Traded on an established market (publicly traded)*—(1) *In general.* Except as provided in paragraph (f)(6) of this section, property (including a debt instrument described in paragraph (b)(1) of this section) is traded on an established market for purposes of this section if, at any time during the 31-day period ending 15 days after the issue date—

(i) There is a sales price for the property as described in paragraph (f)(2) of this section;

(ii) There are one or more firm quotes for the property as described in paragraph (f)(3) of this section; or

(iii) There are one or more indicative quotes for the property as described in paragraph (f)(4) of this section.

(2) *Sales price*—(i) *In general.* A sales price exists if the price for an executed purchase or sale of the property within the 31-day period described in paragraph (f)(1) of this section is reasonably available within a reasonable period of time after the sale.

(ii) *Pricing information for a debt instrument.* For purposes of paragraph (f)(2)(i) of this section, the price of a debt instrument is considered reasonably available if the sales price (or information sufficient to calculate the sales price) appears in a medium that is made available to issuers of debt instruments, persons that regularly purchase or sell debt instruments (including a price provided only to certain customers or to subscribers), or persons that broker purchases or sales of debt instruments.

(3) *Firm quote.* A firm quote is considered to exist when a price quote is available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or to subscribers) for property and the quoted price is substantially the same as the price for which the person receiving the quoted price could purchase or sell the property. A price quote is considered to be available whether the quote is initiated by a person providing the quote or provided at the request of the person receiving the quote. The identity of the person providing the quote must be reasonably ascertainable for a quote to be considered a firm quote for purposes of this paragraph (f)(3). A quote will be considered a firm quote if the quote is designated as a firm quote by the person

providing the quote or if market participants typically purchase or sell, as the case may be, at the quoted price, even if the party providing the quote is not legally obligated to purchase or sell at that price.

(4) *Indicative quote.* An indicative quote is considered to exist when a price quote is available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or to subscribers) for property and the price quote is not a firm quote described in paragraph (f)(3) of this section.

(5) *Presumption that price or quote is equal to fair market value*—(i) *In general.* For purposes of this section, the fair market value of property will be presumed to be equal to its sales price or quoted price determined under paragraphs (f)(2) through (f)(4) of this section. If there is more than one sales price under paragraph (f)(2) of this section, more than one quoted price under paragraph (f)(3) or (f)(4) of this section, or both one or more sales prices under paragraph (f)(2) of this section and quoted prices under paragraph (f)(3) or (f)(4) of this section, a taxpayer may use any reasonable method, consistently applied to the same or substantially similar facts, to determine the fair market value. For example, to determine the fair market value under a reasonable method, a taxpayer may consider factors such as (but not necessarily limited to) the timing of each relevant sale or quote in relation to the issue date; whether the price is derived from a sale, a firm quote, or an indicative quote; the size of each relevant sale or quote; or whether the sales price or quote corresponds to pricing information provided by an independent bond or loan pricing service.

(ii) *Special rule for property for which there is only an indicative quote.* If property is described only in paragraph (f)(4) of this section, and the taxpayer determines that the quote (or an average of the quotes) materially misrepresents the fair market value of the property, the taxpayer can use any method that provides a reasonable basis to determine the fair market value of the property. A taxpayer must establish that the method chosen more accurately reflects the value of the property than the quote or quotes for the property to use the method provided in this paragraph (f)(5)(ii). For an equity or debt instrument, a volume discount or control premium will not be considered to create a material misrepresentation of value for purposes of this paragraph (f)(5)(ii).

(6) *Exception for small debt issues.* Notwithstanding any other provision in paragraph (f) of this section, a debt instrument will not be treated as traded on an established market if at the time the determination is made the outstanding stated principal amount of the issue that includes the debt instrument does not exceed US$100 million (or, for a debt instrument denominated in a currency other than the U.S. dollar, the equivalent amount in the currency in which the debt instrument is denominated).

(7) *Anti-abuse rules*—(i) *Effect of certain temporary restrictions on trading.* If there is any temporary restriction on trading a purpose of which is to avoid the characterization of the property as one that is traded on an established market for Federal income tax purposes, then the property is treated as traded on an established market. For purposes of the preceding sentence, a temporary restriction on trading need not be imposed by the issuer.

(ii) *Artificial pricing information.* If a principal purpose for the existence of any sale or price quotation is to cause the property to be traded on an established market or to materially misrepresent the value of property, that sale or price quotation is disregarded.

(8) *Convertible debt instruments.* A debt instrument is not treated as traded on an established market solely because the debt instrument is convertible into property that is so traded.

(9) *Issuer-holder consistency requirement*—(i) *General rule.* For purposes of this section, an issuer must determine whether property is traded on an established market and, if so, the fair market value of the property. An issuer is required to exercise reasonable diligence to determine whether purchases or sales have taken place, the quantity of purchases and sales, the price at which purchases or sales occurred, the existence of firm or indicative quotes,

and any other relevant information using the rules provided in paragraph (f) of this section to determine the fair market value of the property. If an issuer determines that property is traded on an established market, the issuer is required to make that determination as well as the fair market value of the property (which can be stated as the issue price of the debt instrument) available to holders in a commercially reasonable fashion, including by electronic publication, within 90 days of the date that the debt instrument is issued. Each determination by an issuer is binding on a holder of the debt instrument unless the holder explicitly discloses that its determination is different from the issuer's determination (for example, the holder determines a different fair market value for the property or determines that the property is not traded on an established market). A holder must describe in the disclosure the reasons for its different determination and, if applicable, how the holder determined the fair market value. A holder's disclosure must be filed on a timely filed Federal income tax return for the taxable year that includes the acquisition date of the debt instrument. If an issuer for any reason does not make the fair market value or issue price of a debt instrument reasonably available to a holder, the holder must determine the fair market value of the property and issue price of the debt instrument using the rules provided in paragraph (f) of this section.

(ii) *Co-obligors*. If a debt instrument has more than one obligor, the obligors must designate one obligor (issuer) to determine whether property is traded on an established market and, if so, the fair market value of the property and issue price of the debt instrument and make the price available to holders using the rules provided in paragraph (f)(9)(i) of this section.

(10) *Effective/applicability dates*—(i) This paragraph (f) applies to a debt instrument issued on or after November 13, 2012.

(ii) For rules applying to a debt instrument issued before November 13, 2012, see paragraph (f) of this section as contained in 26 CFR part 1, revised April 1, 2011.

(g) *Treatment of certain cash payments incident to lending transactions*—(1) *Applicability*. The provisions of this paragraph (g) apply to cash payments made incident to private lending transactions (including seller financing).

(2) *Payments from borrower to lender*—(i) *Money lending transaction*. In a lending transaction to which section 1273(b)(2) applies, a payment from the borrower to the lender (other than a payment for property or for services provided by the lender, such as commitment fees or loan processing costs) reduces the issue price of the debt instrument evidencing the loan. However, solely for purposes of determining the tax consequences to the borrower, the issue price is not reduced if the payment is deductible under section 461(g)(2).

(ii) *Section 1274 transaction*. In a lending transaction to which section 1274 applies, a payment from the buyer-borrower to the seller-lender that is designated as interest or points reduces the stated principal amount of the debt instrument evidencing the loan, but is included in the purchase price of the property. If the payment is deductible under section 461(g)(2), however, the issue price of the debt instrument (as otherwise determined under section 1274 and the rule in the preceding sentence) is increased by the amount of the payment to compute the buyer-borrower's interest deductions under section 163.

(3) *Payments from lender to borrower*. A payment from the lender to the borrower in a lending transaction is treated as an amount loaned.

(4) *Payments between lender and third party*. If, as part of a lending transaction, a party other than the borrower (the third party) makes a payment to the lender, that payment is treated in appropriate circumstances as made from the third party to the borrower followed by a payment in the same amount from the borrower to the lender and governed by the provisions of paragraph (g)(2) of this section. If, as part of a lending transaction, the lender makes a payment to a third party, that payment is treated in appropriate circumstances as an additional amount loaned to the borrower and then paid by the borrower to the third party. The

character of the deemed payment between the borrower and the third party depends on the substance of the transaction.

(5) *Examples*. The following examples illustrate the rules of this paragraph (g).

Example 1. Payments from borrower to lender in a cash transaction. (i) *Facts.* A lends $100,000 to B for a term of 10 years. At the time the loan is made, B pays $4,000 in points to A. Assume that the points are not deductible by B under section 461(g)(2) and that the stated redemption price at maturity of the debt instrument is $100,000.

(ii) *Payment results in OID.* Under paragraph (g)(2)(i) of this section, the issue price of B's debt instrument evidencing the loan is $96,000. Because the amount of OID on the debt instrument ($4,000) is more than a de minimis amount of OID, A accounts for the OID under §1.1272–1. B accounts for the OID under §1.163–7.

Example 2. Payments from borrower to lender in a section 1274 transaction. (i) *Facts.* A sells property to B for $1,000,000 in a transaction that is not a potentially abusive situation (within the meaning of §1.1274–3). In consideration for the property, B gives A $300,000 and issues a 5-year debt instrument that has a stated principal amount of $700,000, payable at maturity, and that calls for semiannual payments of interest at a rate of 8.5 percent. In addition to the cash downpayment, B pays A $14,000 designated as points on the loan. Assume that the points are not deductible under section 461(g)(2).

(ii) *Issue price.* Under paragraph (g)(2)(ii) of this section, the stated principal amount of B's debt instrument is −$686,000 ($700,000 minus $14,000). Assuming a test rate of 9 percent, compounded semiannually, the imputed principal amount of B's debt instrument under §1.1274–2(c)(1) is $686,153. Under §1.1274–2(b)(1), the issue price of B's debt instrument is the stated principal amount of $686,000. Because the amount of OID on the debt instrument ($700,000 − $686,000, or $14,000) is more than a de minimis amount of OID, A accounts for the OID under §1.1272–1 and B accounts for the OID under §1.163–7. B's basis in the property purchased is $1,000,000 ($686,000 debt instrument plus $314,000 cash payments).

Example 3. Payments between lender and third party (seller-paid points). (i) *Facts.* A sells real property to B for $500,000 in a transaction that is not a potentially abusive situation (within the meaning of §1.1274–3). B makes a cash down payment of $100,000 and borrows $400,000 of the purchase price from a lender, L, repayable in annual installments over a term of 15 years calling for interest at a rate of 9 percent, compounded annually. As part of the transaction, A makes a payment of $8,000 to L to facilitate the loan to B.

(ii) *Payment results in a de minimis amount of OID.* Under the provisions of paragraphs (g)(2)(i) and (g)(4) of this section, B is treated as having made an $8,000 payment directly to L and a payment of only $492,000 to A for the property. Thus, B's basis in the property is $492,000. The payment to L reduces the issue price of B's debt instrument to $392,000, resulting in $8,000 of OID ($400,000 − $392,000). Because the amount of OID is de minimis under §1.1273–1(d), L accounts for the de minimis OID under §1.1273–1(d)(5). But see §1.1272–3 (election to treat de minimis OID as OID). B accounts for the de minimis OID under §1.163–7.

(h) *Investment units*—(1) *In general.* Under section 1273(c)(2), an investment unit is treated as if the investment unit were a debt instrument. The issue price of the investment unit is determined under paragraph (a)(1), (b)(1), or (c)(1) of this section, if applicable. The issue price of the investment unit is then allocated between the debt instrument and the property right (or rights) that comprise the unit based on their relative fair market values. If paragraphs (a)(1), (b)(1), and (c)(1) of this section are not applicable, however, the issue price of the debt instrument that is part of the investment unit is determined under section 1273(b)(4) or 1274, whichever is applicable.

(2) *Consistent allocation by holders and issuer.* The issuer's allocation of the issue price of the investment unit is binding on all holders of the investment unit. However, the issuer's determination is not binding on a holder that explicitly discloses that its allocation is different from the issuer's allocation. Unless otherwise provided by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed Federal income tax return for the taxable year that includes the acquisition date of the investment unit. See §1.1275–2(e) for rules relating to the issuer's obligation to disclose certain information to holders.

(i) [Reserved]

(j) *Convertible debt instruments.* The issue price of a debt instrument includes any amount paid for an option to convert the instrument into stock (or another debt instrument) of either the issuer or a related party (within the meaning of section 267(b) or

707(b)(1)) or into cash or other property in an amount equal to the approximate value of such stock (or debt instrument). For debt instruments issued on or after February 5, 2013, the term *stock* in the preceding sentence means an equity interest in any entity that is classified, for Federal tax purposes, as either a partnership or a corporation.

(k) *Below-market loans subject to section 7872(b).* The issue price of a below-market loan subject to section 7872(b) (a term loan other than a gift loan) is the issue price determined under this section, reduced by the excess amount determined under section 7872(b)(1).

(l) [Reserved]

(m) *Treatment of amounts representing pre-issuance accrued interest*—(1) *Applicability.* Paragraph (m)(2) of this section provides an alternative to the general rule of this section for determining the issue price of a debt instrument if—

(i) A portion of the initial purchase price of the instrument is allocable to interest that has accrued prior to the issue date (pre-issuance accrued interest); and

(ii) The instrument provides for a payment of stated interest on the first payment date within 1 year of the issue date that equals or exceeds the amount of the pre-issuance accrued interest.

(2) *Exclusion of pre-issuance accrued interest from issue price.* If a debt instrument meets the requirements of paragraph (m)(1) of this section, the instrument's issue price may be computed by subtracting from the issue price (as otherwise computed under this section) the amount of pre-issuance accrued interest. If the issue price of the debt instrument is computed in this manner, a portion of the stated interest payable on the first payment date must be treated as a return of the excluded pre-issuance accrued interest, rather than as an amount payable on the instrument.

(3) *Example.* The following example illustrates the rule of paragraph (m) of this section.

Example: (i) *Facts.* On January 15, 1995, A purchases at original issue, for $1,005, B corporation's debt instrument. The debt instrument provides for a payment of principal of $1,000 on January 1, 2005, and provides for semiannual interest payments of $60 on January 1 and July 1 of each year, beginning on July 1, 1995.

(ii) *Determination of pre-issuance accrued interest.* Under paragraphs (m)(1) and (m)(2) of this section, $5 of the $1,005 initial purchase price of the debt instrument is allocable to pre-issuance accrued interest. Accordingly, the debt instrument's issue price may be computed by subtracting the amount of pre-issuance accrued interest ($5) from the issue price otherwise computed under this section ($1,005), resulting in an issue price of $1,000. If the issue price is computed in this manner, $5 of the $60 payment made on July 1, 1995, must be treated as a repayment by B of the pre-issuance accrued interest.

[T.D. 8517, 59 FR 4817, Feb. 2, 1994, as amended by T.D. 9599, 77 FR 56536, Sept. 13, 2012; T.D. 9612, 78 FR 8016, Feb. 5, 2013]

§ 1.1274–1 Debt instruments to which section 1274 applies.

(a) *In general.* Subject to the exceptions and limitations in paragraph (b) of this section, section 1274 and this section apply to any debt instrument issued in consideration for the sale or exchange of property. For purposes of section 1274, property includes debt instruments and investment units, but does not include money, services, or the right to use property. For the treatment of certain obligations given in exchange for services or the use of property, see sections 404 and 467. For purposes of this paragraph (a), money includes functional currency and, in certain circumstances, nonfunctional currency. See § 1.988–2(b)(2) for circumstances when nonfunctional currency is treated as money rather than as property.

(b) *Exceptions*—(1) *Debt instrument with adequate stated interest and no OID.* Section 1274 does not apply to a debt instrument if—

(i) All interest payable on the instrument is qualified stated interest;

(ii) The stated rate of interest is at least equal to the test rate of interest (as defined in § 1.1274–4);

(iii) The debt instrument is not issued in a potentially abusive situation (as defined in § 1.1274–3); and

(iv) No payment from the buyer-borrower to the seller-lender designated as points or interest is made at the time of issuance of the debt instrument.

(2) *Exceptions under sections 1274(c)(1)(B), 1274(c)(3), 1274A(c), and 1275(b)(1)*—(i) *In general.* Sections

1274(c)(1)(B), 1274(c)(3), 1274A(c), and 1275(b)(1) describe certain transactions to which section 1274 does not apply. This paragraph (b)(2) provides certain rules to be used in applying those exceptions.

(ii) *Special rules for certain exceptions under section 1274(c)(3)*—(A) *Determination of sales price for certain sales of farms.* For purposes of section 1274(c)(3)(A), the determination as to whether the sales price cannot exceed $1,000,000 is made without regard to any other exception to, or limitation on, the applicability of section 1274 (e.g., without regard to the special rules regarding sales of principal residences and land transfers between related persons). In addition, the sales price is determined without regard to section 1274 and without regard to any stated interest. The sales price includes the amount of any liability included in the amount realized from the sale or exchange. See § 1.1001–2.

(B) *Sales involving total payments of $250,000 or less.* Under section 1274(c)(3)(C), the determination of the amount of payments due under all debt instruments and the amount of other consideration to be received is made as of the date of the sale or exchange or, if earlier, the contract date. If the precise amount due under any debt instrument or the precise amount of any other consideration to be received cannot be determined as of that date, section 1274(c)(3)(C) applies only if it can be determined that the maximum of the aggregate amount of payments due under the debt instruments and other consideration to be received cannot exceed $250,000. For purposes of section 1274(c)(3)(C), if a liability is assumed or property is taken subject to a liability, the aggregate amount of payments due includes the outstanding principal balance or adjusted issue price (in the case of an obligation originally issued at a discount) of the obligation.

(C) *Coordination with section 1273 and § 1.1273–2.* In accordance with section 1274(c)(3)(D), section 1274 and this section do not apply if the issue price of a debt instrument issued in consideration for the sale or exchange of property is determined under paragraph (a)(1), (b)(1), or (c)(1) of § 1.1273–2.

(3) *Other exceptions to section 1274*—(i) *Holders of certain below-market instruments.* Section 1274 does not apply to any holder of a debt instrument that is issued in consideration for the sale or exchange of personal use property (within the meaning of section 1275(b)(3)) in the hands of the issuer and that evidences a below-market loan described in section 7872(c)(1).

(ii) *Transactions involving certain demand loans.* Section 1274 does not apply to any debt instrument that evidences a demand loan that is a below-market loan described in section 7872(c)(1).

(iii) *Certain transfers subject to section 1041.* Section 1274 does not apply to any debt instrument issued in consideration for a transfer of property subject to section 1041 (relating to transfers of property between spouses or incident to divorce).

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

Example 1. Single stated rate paid semiannually. A debt instrument issued in consideration for the sale of nonpublicly traded property in a transaction that is not a potentially abusive situation calls for the payment of a principal amount of $1,000,000 at the end of a 10-year term and 20 semiannual interest payments of $60,000. Assume that the test rate of interest is 12 percent, compounded semiannually. The debt instrument is not subject to section 1274 because it provides for interest equal to the test rate and all interest payable on the instrument is qualified stated interest.

Example 2. Sale of farm for debt instrument with contingent interest. (i) *Facts.* On July 1, 1995, A, an individual, sells to B land used as a farm within the meaning of section 6420(c)(2). As partial consideration for the sale, B issues a debt instrument calling for a single $500,000 payment due in 10 years unless profits from the land in each of the 10 years preceding maturity of the debt instrument exceed a specified amount, in which case B is to make a payment of $1,200,000. The debt instrument does not provide for interest.

(ii) *Total payments may exceed $1,000,000.* Even though the total payments ultimately payable under the contract may be less than $1,000,000, at the time of the sale or exchange it cannot be determined that the sales price cannot exceed $1,000,000. Thus, the sale of the land used as a farm is not an excepted transaction described in section 1274(c)(3)(A).

Example 3. Sale between related parties subject to section 483(e). (i) *Facts.* On July 1, 1995, A, an individual, sells land (not used as a farm within the meaning of section

6420(c)(2)) to A's child B for $650,000. In consideration for the sale, B issues a 10-year debt instrument to A that calls for a payment of $650,000. No other consideration is given. The debt instrument does not provide for interest.

(ii) *Treatment of debt instrument.* For purposes of section 483(e), the $650,000 debt instrument is treated as two separate debt instruments: a $500,000 debt instrument and a $150,000 debt instrument. The $500,000 debt instrument is subject to section 483(e), and accordingly is covered by the exception from section 1274 described in section 1274(c)(3)(F). Because the amount of the payments due as consideration for the sale exceeds $250,000, however, the $150,000 debt instrument is subject to section 1274.

[T.D. 8517, 59 FR 4820, Feb. 2, 1994]

§ 1.1274–2 Issue price of debt instruments to which section 1274 applies.

(a) *In general.* If section 1274 applies to a debt instrument, section 1274 and this section determine the issue price of the debt instrument. For rules relating to the determination of the amount and timing of OID to be included in income, see section 1272 and the regulations thereunder.

(b) *Issue price*—(1) *Debt instruments that provide for adequate stated interest; stated principal amount.* The issue price of a debt instrument that provides for adequate stated interest is the stated principal amount of the debt instrument. For purposes of section 1274, the stated principal amount of a debt instrument is the aggregate amount of all payments due under the debt instrument, excluding any amount of stated interest. Under § 1.1273–2(g)(2)(ii), however, the stated principal amount of a debt instrument is reduced by any payment from the buyer- borrower to the seller-lender that is designated as interest or points. See *Example 2* of § 1.1273–2(g)(5).

(2) *Debt instruments that do not provide for adequate stated interest; imputed principal amount.* The issue price of a debt instrument that does not provide for adequate stated interest is the imputed principal amount of the debt instrument.

(3) *Debt instruments issued in a potentially abusive situation; fair market value.* Notwithstanding paragraphs (b)(1) and (b)(2) of this section, in the case of a debt instrument issued in a potentially abusive situation (as defined in § 1.1274–3), the issue price of the debt instrument is the fair market value of the property received in exchange for the debt instrument, reduced by the fair market value of any consideration other than the debt instrument issued in consideration for the sale or exchange.

(c) *Determination of whether a debt instrument provides for adequate stated interest*—(1) *In general.* A debt instrument provides for adequate stated interest if its stated principal amount is less than or equal to its imputed principal amount. Imputed principal amount means the sum of the present values, as of the issue date, of all payments, including payments of stated interest, due under the debt instrument (determined by using a discount rate equal to the test rate of interest as determined under § 1.1274–4). If a debt instrument has a single fixed rate of interest that is paid or compounded at least annually, and that rate is equal to or greater than the test rate, the debt instrument has adequate stated interest.

(2) *Determination of present value.* The present value of a payment is determined by discounting the payment from the date it becomes due to the date of the sale or exchange at the test rate of interest. To determine present value, a compounding period must be selected, and the test rate must be based on the same compounding period.

(d) *Treatment of certain options.* This paragraph (d) provides rules for determining the issue price of a debt instrument to which section 1274 applies (other than a debt instrument issued in a potentially abusive situation) that is subject to one or more options described in both paragraphs (c)(1) and (c)(5) of § 1.1272–1. Under this paragraph (d), an issuer will be deemed to exercise or not exercise an option or combination of options in a manner that minimizes the instrument's imputed principal amount, and a holder will be deemed to exercise or not exercise an option or combination of options in a manner that maximizes the instrument's imputed principal amount. If both the issuer and the holder have options, the rules of this paragraph (d) are applied to the options in the order that they may be exercised. Thus, the

deemed exercise of one option may eliminate other options that are later in time. See § 1.1272–1(c)(5) to determine the debt instrument's yield and maturity for purposes of determining the accrual of OID with respect to the instrument.

(e) *Mandatory sinking funds.* In determining the issue price of a debt instrument to which section 1274 applies (other than a debt instrument issued in a potentially abusive situation) and that is subject to a mandatory sinking fund provision described in § 1.1272–1(c)(3), the mandatory sinking fund provision is ignored.

(f) *Treatment of variable rate debt instruments*—(1) *Stated interest at a qualified floating rate*—(i) *In general.* For purposes of paragraph (c) of this section, the imputed principal amount of a variable rate debt instrument (within the meaning of § 1.1275–5(a)) that provides for stated interest at a qualified floating rate (or rates) is determined by assuming that the instrument provides for a fixed rate of interest for each accrual period to which a qualified floating rate applies. For purposes of the preceding sentence, the assumed fixed rate in each accrual period is the greater of—

(A) The value of the applicable qualified floating rate as of the first date on which there is a binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated; or

(B) The value of the applicable qualified floating rate as of the date on which the sale or exchange occurs.

(ii) *Interest rate restrictions.* Notwithstanding paragraph (f)(1)(i) of this section, if, as a result of interest rate restrictions (such as an interest rate cap), the expected yield of the debt instrument taking the restrictions into account is significantly less than the expected yield of the debt instrument without regard to the restrictions, the interest payments on the debt instrument (other than any fixed interest payments) are treated as contingent payments. Reasonably symmetric interest rate caps and floors, or reasonably symmetric governors, that are fixed throughout the term of the debt instrument do not result in the debt instrument being subject to this rule.

(2) *Stated interest at a single objective rate.* For purposes of paragraph (c) of this section, the imputed principal amount of a variable rate debt instrument (within the meaning of § 1.1275–5(a)) that provides for stated interest at a single objective rate is determined by treating the interest payments as contingent payments.

(g) *Treatment of contingent payment debt instruments.* Notwithstanding paragraph (b) of this section, if a debt instrument subject to section 1274 provides for one or more contingent payments, the issue price of the debt instrument is the lesser of the instrument's noncontingent principal payments and the sum of the present values of the noncontingent payments (as determined under paragraph (c) of this section). However, if the debt instrument is issued in a potentially abusive situation, the issue price of the debt instrument is the fair market value of the noncontingent payments. For additional rules relating to a debt instrument that provides for one or more contingent payments, see § 1.1275–4. This paragraph (g) applies to debt instruments issued on or after August 13, 1996.

(h) *Examples.* The following examples illustrate the rules of this section. Each example assumes a 30-day month, 360-day year. In addition, each example assumes that the debt instrument is not a qualified debt instrument (as defined in section 1274A(b)) and is not issued in a potentially abusive situation.

Example 1. Debt instrument without a fixed rate over its entire term. (i) *Facts.* On January 1, 1995, A sells nonpublicly traded property to B for a stated purchase price of $3,500,000. In consideration for the sale, B makes a down payment of $500,000 and issues a 10-year debt instrument with a stated principal amount of $3,000,000, payable at maturity. The debt instrument calls for no interest in the first 2 years and interest at a rate of 15 percent payable annually over the remaining 8 years of the debt instrument. The first interest payment of $450,000 is due on December 31, 1997, and the last interest payment is due on December 31, 2004, together with the $3,000,000 payment of principal. Assume that the test rate of interest applicable to the debt instrument is 10.5 percent, compounded annually.

(ii) *Applicability of section 1274.* Because the debt instrument does not provide for any interest during the first 2 years, none of the interest on the debt instrument is qualified stated interest. Therefore, the issue price of the debt instrument is determined under section 1274. See §1.1274–1(b)(1). If the debt instrument has adequate stated interest, the issue price of the instrument is its stated principal amount. Otherwise, the issue price of the debt instrument is its imputed principal amount. The debt instrument has adequate stated interest only if the stated principal amount is less than or equal to the imputed principal amount.

(iii) *Determination of imputed principal amount.* To compute the imputed principal amount of the debt instrument, all payments due under the debt instrument are discounted back to the issue date at 10.5 percent, compounded annually, as follows:

(A) The present value of the $3,000,000 principal payment payable on December 31, 2004, is $1,105,346.59, determined as follows:

$$\$1{,}105{,}346.59 = \frac{\$3{,}000{,}000}{(1+.105/1)^{10}}$$

(B) The present value of the eight interest payments of $450,000 as of January 1, 1997, is $2,357,634.55, determined as follows:

$$\$2{,}357{,}634.55 = \$450{,}000 \times \frac{1-(1+.105/1)^{-8}}{(.105/1)}$$

(C) The present value of this interim amount as of January 1, 1995, is $1,930,865.09, determined as follows:

$$\$1{,}930{,}865.09 = \frac{\$2{,}357{,}634.55}{(1+.105/1)^{2}}$$

(iv) *Determination of issue price.* The debt instrument's imputed principal amount (that is, the present value of all payments due under the debt instrument) is $3,036,211.68 ($1,105,346.59 + $1,930,865.09). Because the stated principal amount ($3,000,000) is less than the imputed principal amount, the debt instrument provides for adequate stated interest. Therefore, the issue price of the debt instrument is its stated principal amount ($3,000,000).

Example 2. Debt instrument subject to issuer call option. (i) *Facts.* On January 1, 1995, in partial consideration for the sale of nonpublicly traded property, H corporation issues to G a 10-year debt instrument, maturing on January 1, 2005, with a stated principal amount of $10,000,000, payable on that date. The debt instrument provides for annual payments of interest of 8 percent for the first 5 years and 14 percent for the final 5 years, payable on January 1 of each year, beginning on January 1, 1996. In addition the debt instrument provides H with the unconditional option to call (prepay) the debt instrument at the end of 5 years for its stated principal amount of $10,000,000. Assume that the Federal mid-term and long-term rates applicable to the sale based on annual compounding are 9 percent and 10 percent, respectively.

(ii) *Option presumed exercised.* Assuming exercise of the call option, the imputed principal amount as determined under paragraph (d) of this section is $9,611,034.87 (the present value of all of the payments due within a 5-year term discounted at a test rate of 9 percent, compounded annually). Assuming nonexercise of the call option, the imputed principal amount is $10,183,354.78 (the present value of all of the payments due within a 10-year term discounted at a test rate of 10 percent, compounded annually). For purposes of determining the imputed principal amount, the option is presumed exercised because the imputed principal amount, assuming exercise of the option, is less than the imputed principal amount, assuming the option is not exercised. Because the option is presumed exercised, the debt instrument fails to provide for adequate stated interest because the imputed principal amount ($9,611,034.87) is less than the stated principal amount ($10,000,000). Thus, the issue price of the debt instrument is $9,611,034.87.

Example 3. Variable rate debt instrument with a single rate over its entire term. (i) *Facts.* On January 1, 1995, A sells B nonpublicly traded property. In partial consideration for the sale, B issues a debt instrument in the principal amount of $1,000,000, payable in 5 years. The debt instrument calls for interest payable monthly at a rate of 1 percentage point above the average prime lending rate of a major bank for the month preceding the month of the interest payment. Assume that the test rate of interest applicable to the debt instrument is 10.5 percent, compounded monthly. Assume also that 1 percentage point above the prime lending rate of the designated bank on the date of the sale is 12.5 percent, compounded monthly, which is greater than 1 percentage point above the prime lending rate of the designated bank on the first date on which there is a binding written contract that substantially sets forth the terms under which the sale is consummated.

(ii) *Debt instrument has adequate stated interest.* The debt instrument is a variable rate debt instrument (within the meaning of §1.1275–5) that provides for stated interest at a qualified floating rate. Under paragraph (f)(1)(i) of this section, the debt instrument is treated as if it provided for a fixed rate of interest equal to 12.5 percent, compounded monthly. Because the test rate of interest is 10.5 percent, compounded monthly, the debt instrument provides for adequate stated interest.

Example 4. Debt instrument with a capped variable rate. On July 1, 1995, A sells nonpublicly traded property to B in return for a debt instrument with a stated principal amount of $10,000,000, payable on July 1, 2005. Interest is payable on July 1 of each year, beginning on July 1, 1996, at the Federal short-term rate for June of the same year. The debt instrument provides, however, that the interest rate cannot rise above 8.5 percent, compounded annually. Assume that, as of the date the test rate of interest for the debt instrument is determined, the Federal short-term rate is 8 percent, compounded annually. Assume further that, as a result of the interest rate cap of 8.5 percent, compounded annually, the expected yield of the debt instrument is significantly less than the expected yield of the debt instrument if it did not include the interest rate cap. Under paragraph (f)(1)(ii) of this section, the variable payments are treated as contingent payments for purposes of this section.

(i) [Reserved]

(j) *Special rules for tax-exempt obligations*—(1) *Certain variable rate debt instruments.* Notwithstanding paragraph (b) of this section, if a tax-exempt obligation (as defined in section 1275(a)(3)) is a variable rate debt instrument (within the meaning of §1.1275–5) that pays interest at an objective rate and is subject to section 1274, the issue price of the obligation is the greater of the obligation's fair market value and its stated principal amount.

(2) *Contingent payment debt instruments.* Notwithstanding paragraphs (b) and (g) of this section, if a tax-exempt obligation (as defined in section 1275(a)(3)) is subject to section 1274 and §1.1275–4, the issue price of the obligation is the fair market value of the obligation. However, in the case of a tax-exempt obligation that is subject to §1.1275–4(d)(2) (an obligation that provides for interest-based or revenue-based payments), the issue price of the obligation is the greater of the obligation's fair market value and its stated principal amount.

(3) *Effective date.* This paragraph (j) applies to debt instruments issued on or after August 13, 1996.

[T.D. 8517, 59 FR 4821, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30141, June 14, 1996]

§1.1274–3 Potentially abusive situations defined.

(a) *In general.* For purposes of section 1274, a potentially abusive situation means—

(1) A tax shelter (as defined in section 6662(d)(2)(C)(ii)); or

(2) Any other situation involving—

(i) A recent sales transaction;

(ii) Nonrecourse financing;

(iii) Financing with a term in excess of the useful life of the property; or

(iv) A debt instrument with clearly excessive interest.

(b) *Operating rules*—(1) *Debt instrument exchanged for nonrecourse financing.* Nonrecourse financing does not include an exchange of a nonrecourse debt instrument for an outstanding recourse or nonrecourse debt instrument.

(2) *Nonrecourse debt with substantial down payment.* Nonrecourse financing does not include a sale or exchange of a real property interest financed by a nonrecourse debt instrument if, in addition to the nonrecourse debt instrument, the purchaser makes a down payment in money that equals or exceeds 20 percent of the total stated purchase price of the real property interest. For purposes of the preceding sentence, a real property interest means any interest, other than an interest solely as a creditor, in real property.

(3) *Clearly excessive interest.* Interest on a debt instrument is clearly excessive if the interest, in light of the terms of the debt instrument and the creditworthiness of the borrower, is clearly greater than the arm's length amount of interest that would have been charged in a cash lending transaction between the same two parties.

(4) *Debt-for-debt exchange*—(i) *Rule.* A debt instrument issued in a debt-for-debt exchange, including a deemed exchange under §1.1001–3, will not be treated as the subject of a recent sales transaction for purposes of section 1274(b)(3)(B)(ii)(I) even if the debt instrument exchanged for the newly issued debt instrument was recently acquired prior to the exchange. Therefore, the issue price of the debt instrument will not be determined under section 1274(b)(3). However, if the debt instrument or the property for which the debt instrument is issued is publicly traded within the meaning of §1.1273–

2(f), the rules of § 1.1273–2 will apply to determine the issue price of the debt instrument.

(ii) *Effective/applicability date.* Paragraph (b)(4)(i) of this section applies to a debt instrument issued on or after November 13, 2012.

(c) *Other situations to be specified by Commissioner.* The Commissioner may designate in the Internal Revenue Bulletin situations that, although described in paragraph (a)(2) of this section, will not be treated as potentially abusive because they do not have the effect of significantly misstating basis or amount realized (see § 601.601(d)(2)(ii) of this chapter).

(d) *Consistency rule.* The issuer's determination that the debt instrument is or is not issued in a potentially abusive situation is binding on all holders of the debt instrument. However, the issuer's determination is not binding on a holder who explicitly discloses a position that is inconsistent with the issuer's determination. Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed Federal income tax return for the taxable year that includes the acquisition date of the debt instrument. See § 1.1275–2(e) for rules relating to the issuer's obligation to disclose certain information to holders.

[T.D. 8517, 59 FR 4822, Feb. 2, 1994, as amended by T.D. 9599, 77 FR 56538, Sept. 13, 2012]

§ 1.1274–4 Test rate.

(a) *Determination of test rate of interest*—(1) *In general*—(i) *Test rate is the 3-month rate.* Except as provided in paragraph (a)(2) of this section, the test rate of interest for a debt instrument issued in consideration for the sale or exchange of property is the 3-month rate.

(ii) *The 3-month rate.* Except as provided in paragraph (a)(1)(iii) of this section, the 3-month rate is the lower of—

(A) The lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3-month period ending with the first month in which there is a binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated; or

(B) The lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3-month period ending with the month in which the sale or exchange occurs.

(iii) *Special rule if there is no binding written contract.* If there is no binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated, the 3-month rate is the lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3-month period ending with the month in which the sale or exchange occurs.

(2) *Test rate for certain debt instruments*—(i) *Sale-leaseback transactions.* Under section 1274(e) (relating to certain sale-leaseback transactions), the test rate is 110 percent of the 3-month rate determined under paragraph (a)(1) of this section. For purposes of section 1274(e)(3), related party means a person related to the transferor within the meaning of section 267(b) or 707(b)(1).

(ii) *Qualified debt instrument.* Under section 1274A(a), the test rate for a qualified debt instrument is no greater than 9 percent, compounded semiannually, or an equivalent rate based on an appropriate compounding period.

(iii) *Alternative test rate for short-term obligations*—(A) *Requirements.* This paragraph (a)(2)(iii)(A) provides an alternative test rate under section 1274(d)(1)(D) for a debt instrument with a maturity of 1 year or less. This alternative test rate applies, however, only if the debt instrument provides for adequate stated interest using the alternative test rate, the issuer provides on the face of the debt instrument that the instrument qualifies as having adequate stated interest under section 1274(d)(1)(D), and the issuer and holder treat or agree to treat the instrument as having adequate stated interest.

(B) *Alternative test rate.* For purposes of paragraph (a)(2)(iii)(A), the alternative test rate is the market yield on U.S. Treasury bills with the same maturity date as the debt instrument. If the same maturity date is not available, the market yield on U.S. Treasury bills that mature in the same week or month as the debt instrument is

used. The alternative test rate is determined as of the date on which there is a binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated or as of the date of the sale or exchange, whichever date results in a lower rate. If there is no binding written contract, however, the alternative test rate is determined as of the date of the sale or exchange.

(b) *Applicable Federal rate*. Except as otherwise provided in this section, the applicable Federal rate for a debt instrument is based on the term of the instrument (i.e., short-term, mid-term, or long-term). See section 1274(d)(1). The Internal Revenue Service publishes the applicable Federal rates for each month in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter). The applicable Federal rates are based on the yield to maturity of outstanding marketable obligations of the United States of similar maturities during the one month period ending on the 14th day of the month preceding the month for which the rates are applicable.

(c) *Special rules to determine the term of a debt instrument for purposes of determining the applicable Federal rate*—(1) *Installment obligation*. If a debt instrument is an installment obligation (as defined in § 1.1273–1(e)(1)), the term of the instrument is the instrument's weighted average maturity (as defined in § 1.1273–1(e)(3)).

(2) *Certain variable rate debt instruments*—(i) *In general*. Except as otherwise provided in paragraph (c)(2)(ii) of this section, if a variable rate debt instrument (as defined in § 1.1275–5(a)) provides for stated interest at a qualified floating rate (or rates), the term of the instrument is determined by reference to the longest interval between interest adjustment dates, or, if the variable rate debt instrument provides for a fixed rate, the interval between the issue date and the last day on which the fixed rate applies, if this interval is longer.

(ii) *Restrictions on adjustments*. If, due to significant restrictions on variations in a qualified floating rate or the use of certain formulae pursuant to § 1.1275–5(b)(2) (e.g., 15 percent of 1-year LIBOR, plus 800 basis points), the rate in substance resembles a fixed rate, the applicable Federal rate is determined by reference to the term of the debt instrument.

(3) *Counting of either the issue date or the maturity date*. The term of a debt instrument includes either the issue date or the maturity date, but not both dates.

(4) *Certain debt instruments that provide for principal payments uncertain as to time*. If a debt instrument provides for principal payments that are fixed in total amount but uncertain as to time, the term of the instrument is determined by reference to the latest possible date on which a principal payment can be made or, in the case of an installment obligation, by reference to the longest weighted average maturity under any possible payment schedule.

(d) *Foreign currency loans*. If all of the payments of a debt instrument are denominated in, or determined by reference to, a currency other than the U.S. dollar, the applicable Federal rate for the debt instrument is a foreign currency rate of interest that is analogous to the applicable Federal rate described in this section. For this purpose, an analogous rate of interest is a rate based on yields (with the appropriate compounding period) of the highest grade of outstanding marketable obligations denominated in such currency (excluding any obligations that benefit from special tax exemptions or preferential tax rates not available to debt instruments generally) with due consideration given to the maturities of the obligations.

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

Example 1. Variable rate debt instrument that limits the amount of increase and decrease in the rate. (i) *Facts*. On July 1, 1996, A sells nonpublicly traded property to B in return for a 5-year debt instrument that provides for interest to be paid on July 1 of each year, beginning on July 1, 1997, based on the prime rate of a local bank on that date. However, the interest rate cannot increase or decrease from one year to the next by more than .25 percentage points (25 basis points).

(ii) *Significant restriction*. The debt instrument is a variable rate debt instrument (as defined in § 1.1275–5) that provides for stated interest at a qualified floating rate. Assume that based on all the facts and circumstances, the restriction is a significant restriction on the variations in the rate of

interest. Under paragraph (c)(2)(ii) of this section, the applicable Federal rate is determined by reference to the term of the debt instrument, and the applicable Federal rate is the Federal mid-term rate.

Example 2. Installment obligation. (i) *Facts.* On January 1, 1996, A sells nonpublicly traded property to B in exchange for a debt instrument that calls for a payment of $500,000 on January 1, 2001, and a payment of $1,000,000 on January 1, 2006. The debt instrument does not provide for any stated interest.

(ii) *Determination of term.* The debt instrument is an installment obligation. Under paragraph (c)(1) of this section, the term of the debt instrument is its weighted average maturity (as defined in §1.1273–1(e)(3)). The debt instrument's weighted average maturity is 8.33 years, which is the sum of (A) the ratio of the first payment to total payments (500,000/1,500,000), multiplied by the number of complete years from the issue date until the payment is due (5 years), and (B) the ratio of the second payment to total payments (1,000,000/1,500,000), multiplied by the number of complete years from the issue date until the second payment is due (10 years).

(iii) *Applicable Federal rate.* Based on the calculation in paragraph (ii) of this example, the term of the debt instrument is treated as 8.33 years. Consequently, the applicable Federal rate is the Federal mid-term rate.

[T.D. 8517, 59 FR 4823, Feb. 2, 1994]

§ 1.1274–5 Assumptions.

(a) *In general.* Section 1274 does not apply to a debt instrument if the debt instrument is assumed, or property is taken subject to the debt instrument, in connection with a sale or exchange of property, unless the terms of the debt instrument, as part of the sale or exchange, are modified in a manner that would constitute an exchange under section 1001.

(b) *Modifications of debt instruments*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, if a debt instrument is assumed, or property is taken subject to a debt instrument, in connection with a sale or exchange of property, the terms of the debt instrument are modified as part of the sale or exchange, and the modification triggers an exchange under section 1001, the modification is treated as a separate transaction taking place immediately before the sale or exchange and is attributed to the seller of the property. For purposes of this paragraph (b), a debt instrument is not considered to be modified as part of the sale or exchange unless the seller knew or had reason to know about the modification.

(2) *Election to treat buyer as modifying the debt instrument*—(i) *In general.* Rather than having the rules in paragraph (b)(1) of this section apply, the seller and buyer may jointly elect to treat the transaction as one in which the buyer first assumed the original (unmodified) debt instrument and then subsequently modified the debt instrument. For this purpose, the modification is treated as a separate transaction taking place immediately after the sale or exchange.

(ii) *Time and manner of making the election.* The buyer and seller make the election under paragraph (b)(2)(i) of this section by jointly signing a statement that includes the names, addresses, and taxpayer identification numbers of the seller and buyer, and a clear indication that the election is being made under paragraph (b)(2)(i) of this section. Both the buyer and the seller must sign this statement not later than the earlier of the last day (including extensions) for filing the Federal income tax return of the buyer or seller for the taxable year in which the sale or exchange of the property occurs. The buyer and seller should attach this signed statement (or a copy thereof) to their timely filed Federal income tax returns.

(c) *Wraparound indebtedness.* For purposes of paragraph (a) of this section, the issuance of wraparound indebtedness is not considered an assumption.

(d) *Consideration attributable to assumed debt.* If, as part of the consideration for the sale or exchange of property, the buyer assumes, or takes the property subject to, an indebtedness that was issued with OID (including a debt instrument issued in a prior sale or exchange to which section 1274 applied), the portion of the buyer's basis in the property and the seller's amount realized attributable to the debt instrument equals the adjusted issue price of the debt instrument as of the date of the sale or exchange.

[T.D. 8517, 59 FR 4824, Feb. 2, 1994]

§ 1.1274A–1 Special rules for certain transactions where stated principal amount does not exceed $2,800,000.

(a) *In general*. Section 1274A allows the use of a lower test rate for purposes of sections 483 and 1274 in the case of a qualified debt instrument (as defined in section 1274A(b)) and, if elected by the borrower and the lender, the use of the cash receipts and disbursements method of accounting for interest on a cash method debt instrument (as defined in section 1274A(c)(2)). This section provides special rules for qualified debt instruments and cash method debt instruments.

(b) *Rules for both qualified and cash method debt instruments*—(1) *Sale-leaseback transactions*. A debt instrument issued in a sale-leaseback transaction (within the meaning of section 1274(e)) cannot be either a qualified debt instrument or a cash method debt instrument.

(2) *Debt instruments calling for contingent payments*. A debt instrument that provides for contingent payments cannot be a qualified debt instrument unless it can be determined at the time of the sale or exchange that the maximum stated principal amount due under the debt instrument cannot exceed the amount specified in section 1274A(b). Similarly, a debt instrument that provides for contingent payments cannot be a cash method debt instrument unless it can be determined at the time of the sale or exchange that the maximum stated principal amount due under the debt instrument cannot exceed the amount specified in section 1274A(c)(2)(A).

(3) *Aggregation of transactions*—(i) *General rule*. The aggregation rules of section 1274A(d)(1) are applied using a facts and circumstances test.

(ii) *Examples*. The following examples illustrate the application of section 1274A(d)(1) and paragraph (b)(3)(i) of this section.

Example 1. Aggregation of two sales to a single person. In two transactions evidenced by separate sales agreements, A sells undivided half interests in Blackacre to B. The sales are pursuant to a plan for the sale of a 100 percent interest in Blackacre to B. These sales or exchanges are part of a series of related transactions and, thus, are treated as a single sale for purposes of section 1274A.

Example 2. Aggregation of two purchases by unrelated individuals. Pursuant to a plan, unrelated individuals X and Y purchase undivided half interests in Blackacre from A and subsequently contribute these interests to a partnership in exchange for equal interests in the partnership. These purchases are treated as part of the same transaction and, thus, are treated as a single sale for purposes of section 1274A.

Example 3. Aggregation of sales made pursuant to a tender offer. Fifteen unrelated individuals own all of the stock of X Corporation. Y Corporation makes a tender offer to these 15 shareholders. The terms offered to each shareholder are identical. Shareholders holding a majority of the shares of X Corporation elect to tender their shares pursuant to Y Corporation's offer. These sales are part of the same transaction and, thus, are treated as a single sale for purposes of section 1274A.

Example 4. No aggregation for separate sales of similar property to unrelated persons. Pursuant to a newspaper advertisement, X Corporation offers for sale similar condominiums in a single building. The prices of the units vary due to a variety of factors, but the financing terms offered by X Corporation to all buyers are identical. The units are purchased by unrelated buyers who decided whether to purchase units in the building at the price and on the terms offered by X Corporation, without regard to the actions of other buyers. Because each buyer acts individually, the sales are not part of the same transaction or a series of related transactions and, thus, are treated as separate sales.

(4) *Inflation adjustment of dollar amounts*. Under section 1274A(d)(2), the dollar amounts specified in sections 1274A(b) and 1274A(c)(2)(A) are adjusted for inflation. The dollar amounts, adjusted for inflation, are published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter).

(c) *Rules for cash method debt instruments*—(1) *Time and manner of making cash method election*. The borrower and lender make the election described in section 1274A(c)(2)(D) by jointly signing a statement that includes the names, addresses, and taxpayer identification numbers of the borrower and lender, a clear indication that an election is being made under section 1274A(c)(2), and a declaration that the debt instrument with respect to which the election is being made fulfills the requirements of a cash method debt instrument. Both the borrower and the lender must sign this statement not later

than the earlier of the last day (including extensions) for filing the Federal income tax return of the borrower or lender for the taxable year in which the debt instrument is issued. The borrower and lender should attach this signed statement (or a copy thereof) to their timely filed Federal income tax returns.

(2) *Successors of electing parties.* Except as otherwise provided in this paragraph (c)(2), the cash method election under section 1274A(c) applies to any successor of the electing lender or borrower. Thus, for any period after the transfer of a cash method debt instrument, the successor takes into account the interest (including unstated interest) on the instrument under the cash receipts and disbursements method of accounting. Nevertheless, if the lender (or any successor thereof) transfers the cash method debt instrument to a taxpayer who uses an accrual method of accounting, section 1272 rather than section 1274A(c) applies to the successor of the lender with respect to the debt instrument for any period after the date of the transfer. The borrower (or any successor thereof), however, remains on the cash receipts and disbursements method of accounting with respect to the cash method debt instrument.

(3) *Modified debt instrument.* In the case of a debt instrument issued in a debt-for-debt exchange that qualifies as an exchange under section 1001, the debt instrument is eligible for the election to be a cash method debt instrument if the other prerequisites to making the election in section 1274A(c) are met. However, if a principal purpose of the modification is to defer interest income or deductions through the use of the election, then the debt instrument is not eligible for the election.

(4) *Debt incurred or continued to purchase or carry a cash method debt instrument.* If a debt instrument is incurred or continued to purchase or carry a cash method debt instrument, rules similar to those under section 1277 apply to determine the timing of the interest deductions for the debt instrument. For purposes of the preceding sentence, rules similar to those under section 265(a)(2) apply to determine whether a debt instrument is incurred or continued to purchase or carry a cash method debt instrument.

[T.D. 8517, 59 FR 4824, Feb. 2, 1994]

§ 1.1275–1 Definitions.

(a) *Applicability.* The definitions contained in this section apply for purposes of sections 163(e) and 1271 through 1275 and the regulations thereunder.

(b) *Adjusted issue price*—(1) *In general.* The adjusted issue price of a debt instrument at the beginning of the first accrual period is the issue price. Thereafter, the adjusted issue price of the debt instrument is the issue price of the debt instrument—

(i) Increased by the amount of OID previously includible in the gross income of any holder (determined without regard to section 1272(a)(7) and section 1272(c)(1)); and

(ii) Decreased by the amount of any payment previously made on the debt instrument other than a payment of qualified stated interest. See § 1.1275–2(f) for rules regarding adjustments to adjusted issue price on a pro rata prepayment.

(2) *Bond issuance premium.* If a debt instrument is issued with bond issuance premium (as defined in § 1.163–13(c)), for purposes of determining the issuer's adjusted issue price, the adjusted issue price determined under paragraph (b)(1) of this section is also decreased by the amount of bond issuance premium previously allocable under § 1.163–13(d)(3).

(3) *Adjusted issue price for subsequent holders.* For purposes of calculating OID accruals, acquisition premium, or market discount, a holder (other than a purchaser at original issuance) determines adjusted issue price in any manner consistent with the regulations under sections 1271 through 1275.

(c) *OID.* OID means original issue discount (as defined in section 1273(a) and § 1.1273–1).

(d) *Debt instrument.* Except as provided in section 1275(a)(1)(B) (relating to certain annuity contracts; see paragraph (j) of this section), debt instrument means any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law (including, for example, a certificate of deposit or

a loan). Nothing in the regulations under sections 163(e), 483, and 1271 through 1275, however, shall influence whether an instrument constitutes indebtedness for Federal income tax purposes. See §1.385–3 for rules that treat certain instruments that otherwise would be treated as indebtedness as stock for Federal tax purposes.

(e) *Tax-exempt obligations*. For purposes of section 1275(a)(3)(B), exempt from tax means exempt from Federal income tax.

(f) *Issue*. (1) *Debt instruments issued on or after March 13, 2001*.

(2) *Debt instruments issued before March 13, 2001*.

(3) *Transition rule*.

(4) *Cross-references for reopening and aggregation rules*.

(g) *Debt instruments issued by a natural person*. If an entity is a primary obligor under a debt instrument, the debt instrument is considered to be issued by the entity and not by a natural person even if a natural person is a co-maker and is jointly liable for the debt instrument's repayment. A debt instrument issued by a partnership is considered to be issued by the partnership as an entity even if the partnership is composed entirely of natural persons.

(h) *Publicly offered debt instrument*. A debt instrument is publicly offered if it is part of an issue of debt instruments the initial offering of which—

(1) Is registered with the Securities and Exchange Commission; or

(2) Would be required to be registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) but for an exemption from registration—

(i) Under section 3 of the Securities Act of 1933 (relating to exempted securities);

(ii) Under any law (other than the Securities Act of 1933) because of the identity of the issuer or the nature of the security; or

(iii) Because the issue is intended for distribution to persons who are not United States persons.

(i) [Reserved]

(j) *Life annuity exception under section 1275(a)(1)(B)(i)*—(1) *Purpose*. Section 1275(a)(1)(B)(i) excepts an annuity contract from the definition of *debt instrument* if section 72 applies to the contract and the contract depends (in whole or in substantial part) on the life expectancy of one or more individuals. This paragraph (j) provides rules to ensure that an annuity contract qualifies for the exception in section 1275(a)(1)(B)(i) only in cases where the life contingency under the contract is real and significant.

(2) *General rule*—(i) *Rule*. For purposes of section 1275(a)(1)(B)(i), an annuity contract depends (in whole or in substantial part) on the life expectancy of one or more individuals only if—

(A) The contract provides for periodic distributions made not less frequently than annually for the life (or joint lives) of an individual (or a reasonable number of individuals); and

(B) The contract does not contain any terms or provisions that can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants).

(ii) *Terminology*. For purposes of this paragraph (j):

(A) *Contract*. The term *contract* includes all written or unwritten understandings among the parties as well as any person or persons acting in concert with one or more of the parties.

(B) *Annuitant*. The term *annuitant* refers to the individual (or reasonable number of individuals) referred to in paragraph (j)(2)(i)(A) of this section.

(C) *Terminating death*. The phrase *terminating death* refers to the annuitant death that can terminate periodic distributions under the contract. (See paragraph (j)(2)(i)(A) of this section.) For example, if a contract provides for periodic distributions until the later of the death of the last-surviving annuitant or the end of a term certain, the terminating death is the death of the last-surviving annuitant.

(iii) *Coordination with specific rules*. Paragraphs (j) (3) through (7) of this section describe certain terms and conditions that can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). If a term or provision is not specifically described in paragraphs (j) (3) through (7) of this section, the annuity contract must be

tested under the general rule of paragraph (j)(2)(i) of this section to determine whether it depends (in whole or in substantial part) on the life expectancy of one or more individuals.

(3) *Availability of a cash surrender option*—(i) *Impact on life contingency*. The availability of a cash surrender option can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). Thus, the availability of any cash surrender option causes the contract to fail to be described in section 1275(a)(1)(B)(i). A cash surrender option is available if there is reason to believe that the issuer (or a person acting in concert with the issuer) will be willing to terminate or purchase all or a part of the annuity contract by making one or more payments of cash or property (other than an annuity contract described in this paragraph (j)).

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

Example 1. (i) *Facts*. On March 1, 1998, X issues a contract to A for cash. The contract provides that, effective on any date chosen by A (the annuity starting date), X will begin equal monthly distributions for A's life. The amount of each monthly distribution will be no less than an amount based on the contract's account value as of the annuity starting date, A's age on that date, and permanent purchase rate guarantees contained in the contract. The contract also provides that, at any time before the annuity starting date, A may surrender the contract to X for the account value less a surrender charge equal to a declining percentage of the account value. For this purpose, the initial account value is equal to the cash invested. Thereafter, the account value increases annually by at least a minimum guaranteed rate.

(ii) *Analysis*. The ability to obtain the account value less the surrender charge, if any, is a cash surrender option. This ability can significantly reduce the probability that total distributions under the contract will increase commensurately with A's longevity. Thus, the contract fails to be described in section 1275(a)(1)(B)(i).

Example 2. (i) *Facts*. On March 1, 1998, X issues a contract to B for cash. The contract provides that beginning on March 1, 1999, X will distribute to B a fixed amount of cash each month for B's life. Based on X's advertisements, marketing literature, or illustrations or on oral representations by X's sales personnel, there is reason to believe that an affiliate of X stands ready to purchase B's contract for its commuted value.

(ii) *Analysis*. Because there is reason to believe that an affiliate of X stands ready to purchase B's contract for its commuted value, a cash surrender option is available within the meaning of paragraph (j)(3)(i) of this section. This availability can significantly reduce the probability that total distributions under the contract will increase commensurately with B's longevity. Thus, the contract fails to be described in section 1275(a)(1)(B)(i).

(4) *Availability of a loan secured by the contract*—(i) *Impact on life contingency*. The availability of a loan secured by the contract can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). Thus, the availability of any such loan causes the contract to fail to be described in section 1275(a)(1)(B)(i). A loan secured by the contract is available if there is reason to believe that the issuer (or a person acting in concert with the issuer) will be willing to make a loan that is directly or indirectly secured by the annuity contract.

(ii) *Example*. The following example illustrates the rules of this paragraph (j)(4):

Example: (i) *Facts*. On March 1, 1998, X issues a contract to C for $100,000. The contract provides that, effective on any date chosen by C (the annuity starting date), X will begin equal monthly distributions for C's life. The amount of each monthly distribution will be no less than an amount based on the contract's account value as of the annuity starting date, C's age on that date, and permanent purchase rate guarantees contained in the contract. From marketing literature circulated by Y, there is reason to believe that, at any time before the annuity starting date, C may pledge the contract to borrow up to $75,000 from Y. Y is acting in concert with X.

(ii) *Analysis*. Because there is reason to believe that Y, a person acting in concert with X, is willing to lend money against C's contract, a loan secured by the contract is available within the meaning of paragraph (j)(4)(i) of this section. This availability can significantly reduce the probability that total distributions under the contract will increase commensurately with C's longevity. Thus, the contract fails to be described in section 1275(a)(1)(B)(i).

(5) *Minimum payout provision*—(i) *Impact on life contingency*. The existence of a minimum payout provision can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). Thus, the existence of any minimum payout provision causes the contract to fail to be described in section 1275(a)(1)(B)(i).

(ii) *Definition of minimum payout provision*. A minimum payout provision is a contractual provision (for example, an agreement to make distributions over a term certain) that provides for one or more distributions made—

(A) After the terminating death under the contract; or

(B) By reason of the death of any individual (including distributions triggered by or increased by terminal or chronic illness, as defined in section 101(g)(1) (A) and (B)).

(iii) *Exceptions for certain minimum payouts*—(A) *Recovery of consideration paid for the contract*. Notwithstanding paragraphs (j)(2)(i)(A) and (j)(5)(i) of this section, a contract does not fail to be described in section 1275(a)(1)(B)(i) merely because it provides that, after the terminating death, there will be one or more distributions that, in the aggregate, do not exceed the consideration paid for the contract less total distributions previously made under the contract.

(B) *Payout for one-half of life expectancy*. Notwithstanding paragraphs (j)(2)(i)(A) and (j)(5)(i) of this section, a contract does not fail to be described in section 1275(a)(1)(B)(i) merely because it provides that, if the terminating death occurs after the annuity starting date, distributions under the contract will continue to be made after the terminating death until a date that is no later than the halfway date. This exception does not apply unless the amounts distributed in each contract year will not exceed the amounts that would have been distributed in that year if the terminating death had not occurred until the expected date of the terminating death, determined under paragraph (j)(5)(iii)(C) of this section.

(C) *Definition of halfway date*. For purposes of this paragraph (j)(5)(iii), the halfway date is the date halfway between the annuity starting date and the expected date of the terminating death, determined as of the annuity starting date, with respect to all then-surviving annuitants. The expected date of the terminating death must be determined by reference to the applicable mortality table prescribed under section 417(e)(3)(A)(ii)(I).

(iv) *Examples*. The following examples illustrate the rules of this paragraph (j)(5):

Example 1. (i) *Facts*. On March 1, 1998, X issues a contract to D for cash. The contract provides that, effective on any date D chooses (the annuity starting date), X will begin equal monthly distributions for the greater of D's life or 10 years, regardless of D's age as of the annuity starting date. The amount of each monthly distribution will be no less than an amount based on the contract's account value as of the annuity starting date, D's age on that date, and permanent purchase rate guarantees contained in the contract.

(ii) *Analysis*. A minimum payout provision exists because, if D dies within 10 years of the annuity starting date, one or more distributions will be made after D's death. The minimum payout provision does not qualify for the exception in paragraph (j)(5)(iii)(B) of this section because D may defer the annuity starting date until his remaining life expectancy is less than 20 years. If, on the annuity starting date, D's life expectancy is less than 20 years, the minimum payout period (10 years) will last beyond the halfway date. The minimum payout provision, therefore, can significantly reduce the probability that total distributions under the contract will increase commensurately with D's longevity. Thus, the contract fails to be described in section 1275(a)(1)(B)(i).

Example 2. (i) *Facts*. The facts are the same as in *Example 1* of this paragraph (j)(5)(iv) except that the monthly distributions will last for the greater of D's life or a term certain. D may choose the length of the term certain subject to the restriction that, on the annuity starting date, the term certain must not exceed one-half of D's life expectancy as of the annuity starting date. The contract also does not provide for any adjustment in the amount of distributions by reason of the death of D or any other individual, except for a refund of D's aggregate premium payments less the sum of all prior distributions under the contract.

(ii) *Analysis*. The minimum payout provision qualifies for the exception in paragraph (j)(5)(iii)(B) of this section because distributions under the minimum payout provision will not continue past the halfway date and

the contract does not provide for any adjustments in the amount of distributions by reason of the death of D or any other individual, other than a guaranteed death benefit described in paragraph (j)(5)(iii)(A) of this section. Accordingly, the existence of this minimum payout provision does not prevent the contract from being described in section 1275(a)(1)(B)(i).

(6) *Maximum payout provision*—(i) *Impact on life contingency*. The existence of a maximum payout provision can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). Thus, the existence of any maximum payout provision causes the contract to fail to be described in section 1275(a)(1)(B)(i).

(ii) *Definition of maximum payout provision*. A maximum payout provision is a contractual provision that provides that no distributions under the contract may be made after some date (the termination date), even if the terminating death has not yet occurred.

(iii) *Exception*. Notwithstanding paragraphs (j)(2)(i)(A) and (j)(6)(i) of this section, an annuity contract does not fail to be described in section 1275(a)(1)(B)(i) merely because the contract contains a maximum payout provision, provided that the period of time from the annuity starting date to the termination date is at least twice as long as the period of time from the annuity starting date to the expected date of the terminating death, determined as of the annuity starting date, with respect to all then-surviving annuitants. The expected date of the terminating death must be determined by reference to the applicable mortality table prescribed under section 417(e)(3)(A)(ii)(I).

(iv) *Example*. The following example illustrates the rules of this paragraph (j)(6):

Example: (i) *Facts*. On March 1, 1998, X issues a contract to E for cash. The contract provides that beginning on April 1, 1998, X will distribute to E a fixed amount of cash each month for E's life but that no distributions will be made after April 1, 2018. On April 1, 1998, E's life expectancy is 9 years.

(ii) *Analysis*. A maximum payout provision exists because if E survives beyond April 1, 2018, E will receive no further distributions under the contract. The period of time from the annuity starting date (April 1, 1998) to the termination date (April 1, 2018) is 20 years. Because this 20-year period is more than twice as long as E's life expectancy on April 1, 1998, the maximum payout provision qualifies for the exception in paragraph (j)(6)(iii) of this section. Accordingly, the existence of this maximum payout provision does not prevent the contract from being described in section 1275(a)(1)(B)(i).

(7) *Decreasing payout provision*—(i) *General rule*. If the amount of distributions during any contract year (other than the last year during which distributions are made) may be less than the amount of distributions during the preceding year, this possibility can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). Thus, the existence of this possibility causes the contract to fail to be described in section 1275(a)(1)(B)(i).

(ii) *Exception for certain variable distributions*. Notwithstanding paragraph (j)(7)(i) of this section, if an annuity contract provides that the amount of each distribution must increase and decrease in accordance with investment experience, cost of living indices, or similar fluctuating criteria, then the possibility that the amount of a distribution may decrease for this reason does not significantly reduce the probability that the distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants).

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

Example 1. (i) *Facts*. On March 1, 1998, X issues a contract to F for $100,000. The contract provides that beginning on March 1, 1999, X will make distributions to F each year until F's death. Prior to March 1, 2009, distributions are to be made at a rate of $12,000 per year. Beginning on March 1, 2009, distributions are to be made at a rate of $3,000 per year.

(ii) *Analysis*. If F is alive in 2009, the amount distributed in 2009 ($3,000) will be less than the amount distributed in 2008 ($12,000). The exception in paragraph (j)(7)(ii) of this section does not apply. The decrease in the amount of any distributions made on or after March 1, 2009, can significantly reduce the probability that total distributions under the contract will increase commensurately with F's longevity. Thus, the contract fails to be described in section 1275(a)(1)(B)(i).

Example 2. (i) *Facts.* On March 1, 1998, X issues a contract to G for cash. The contract provides that, effective on any date G chooses (the annuity starting date), X will begin monthly distributions to G for G's life. Prior to the annuity starting date, the account value of the contract reflects the investment return, including changes in the market value, of an identifiable pool of assets. When G chooses the annuity starting date, G must also choose whether the distributions are to be fixed or variable. If fixed, the amount of each monthly distribution will remain constant at an amount that is no less than an amount based on the contract's account value as of the annuity starting date, G's age on that date, and permanent purchase rate guarantees contained in the contract. If variable, the monthly distributions will fluctuate to reflect the investment return, including changes in the market value, of the pool of assets. The monthly distributions under the contract will not otherwise decline from year to year.

(ii) *Analysis.* Because the only possible year-to-year declines in annuity distributions are described in paragraph (j)(7)(ii) of this section, the possibility that the amount of distributions may decline from the previous year does not reduce the probability that total distributions under the contract will increase commensurately with G's longevity. Thus, the potential fluctuation in the annuity distributions does not cause the contract to fail to be described in section 1275(a)(1)(B)(i).

(8) *Effective dates*—(i) *In general.* Except as provided in paragraph (j)(8) (ii) and (iii) of this section, this paragraph (j) is applicable for interest accruals on or after February 9, 1998 on annuity contracts held on or after February 9, 1998.

(ii) *Grandfathered contracts.* This paragraph (j) does not apply to an annuity contract that was purchased before April 7, 1995. For purposes of this paragraph (j)(8), if any additional investment in such a contract is made on or after April 7, 1995, and the additional investment is not required to be made under a binding contractual obligation that was entered into before April 7, 1995, then the additional investment is treated as the purchase of a contract after April 7, 1995.

(iii) *Contracts consistent with the provisions of FI–33–94, published at 1995–1 C.B. 920. See § 601.601(d)(2)(ii)(b) of this chapter.* This paragraph (j) does not apply to a contract purchased on or after April 7, 1995, and before February 9, 1998, if all payments under the contract are periodic payments that are made at least annually for the life (or lives) of one or more individuals, do not increase at any time during the term of the contract, and are part of a series of distributions that begins within one year of the date of the initial investment in the contract. An annuity contract that is otherwise described in the preceding sentence does not fail to be described therein merely because it also provides for a payment (or payments) made by reason of the death of one or more individuals.

(k) *Exception under section 1275(a)(1)(B)(ii) for annuities issued by an insurance company subject to tax under subchapter L of the Internal Revenue Code*—(1) *Rule.* For purposes of section 1275(a)(1)(B)(ii), an annuity contract issued by a foreign insurance company is considered as issued by an insurance company subject to tax under subchapter L if the insurance company is subject to tax under subchapter L with respect to income earned on the annuity contract.

(2) *Examples.* The following examples illustrate the rule of paragraph (k)(1) of this section. Each example assumes that the annuity contract is a contract to which section 72 applies and was issued in a transaction where there is no consideration other than cash or another qualifying annuity contract, pursuant to the exercise of an election under an insurance contract by a beneficiary thereof on the death of the insured party, or in a transaction involving a qualified pension or employee benefit plan. The examples are as follows:

Example 1. Company X is an insurance company that is organized, licensed and doing business in Country Y. Company X does not have a U.S. trade or business and is not, under section 842, subject to U.S. income tax under subchapter L with respect to income earned on annuity contracts. A, a U.S. taxpayer, purchases an annuity contract from Company X in Country Y. The annuity contract is not excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 2. The facts are the same as in Example 1, except that Company X has a U.S. trade or business. A purchased the annuity from Company X's U.S. trade or business. Under section 842(a), Company X is subject to tax under subchapter L with respect to income earned on the annuity contract. Under these facts, the annuity contract is excepted

from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 3. The facts are the same as in *Example 2,* except that there is a tax treaty between Country Y and the United States. Company X is a resident of Country Y for purposes of the U.S.-Country Y tax treaty. Company X's activities in the U.S. do not constitute a permanent establishment under the U.S.-Country Y tax treaty. Because Company X does not have a U.S. permanent establishment, Company X is not subject to tax under subchapter L with respect to income earned on the annuity contract. Thus, the annuity contract is not excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 4. The facts are the same as in *Example 1,* except that Company X is a foreign insurance corporation controlled by a U.S. shareholder. Company X does not make an election 1 under section 953(d) to be treated as a domestic corporation. The controlling U.S. shareholder is required under sections 953 and 954 to include income earned on the annuity contract in its taxable income under subpart F. However, Company X is not subject to tax under subchapter L with respect to income earned on the annuity contract. Thus, the annuity contract is not excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 5. The facts are the same as in *Example 4,* except that Company X properly elects under section 953(d) to be treated as a domestic corporation. By reason of its election, Company X is subject to tax under subchapter L with respect to income earned on the annuity contract. Thus, the annuity contract is excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

(3) *Effective date.* This paragraph (k) is applicable for interest accruals on or after June 6, 2002. This paragraph (k) does not apply to an annuity contract that was purchased before January 12, 2001. For purposes of this paragraph (k), if any additional investment in a contract purchased before January 12, 2001, is made on or after January 12, 2001, and the additional investment is not required to be made under a binding written contractual obligation that was entered into before that date, then the additional investment is treated as the purchase of a contract after January 12, 2001.

[T.D. 8517, 59 FR 4825, Feb. 2, 1994, as amended by T.D. 8746, 62 FR 68183, Dec. 31, 1997; T.D. 8754, 63 FR 1057, Jan. 8, 1998; T.D. 8934, 66 FR 2815, Jan. 12, 2001; T.D. 8993, 67 FR 30548, May 7, 2002; T.D. 9790, 81 FR 72984, Oct. 21, 2016: T.D. 9880, 84 FR 59302, Nov. 4, 2019]

§ 1.1275–2 Special rules relating to debt instruments.

(a) *Payment ordering rule*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, each payment under a debt instrument is treated first as a payment of OID to the extent of the OID that has accrued as of the date the payment is due and has not been allocated to prior payments, and second as a payment of principal. Thus, no portion of any payment is treated as prepaid interest.

(2) *Exceptions.* The rule in paragraph (a)(1) of this section does not apply to—

(i) A payment of qualified stated interest;

(ii) A payment of points deductible under section 461(g)(2), in the case of the issuer;

(iii) A pro rata prepayment described in paragraph (f)(2) of this section; or

(iv) A payment of additional interest or a similar charge provided with respect to amounts that are not paid when due.

(b) *Debt instruments distributed by corporations with respect to stock*—(1) *Treatment of distribution.* For purposes of determining the issue price of a debt instrument distributed by a corporation with respect to its stock, the instrument is treated as issued by the corporation for property. See section 1275(a)(4). Thus, under section 1273(b)(3), the issue price of a distributed debt instrument that is traded on an established market is its fair market value. The issue price of a distributed debt instrument that is not traded on an established market is determined under section 1274 or section 1273(b)(4).

(2) *Issue date.* The issue date of a debt instrument distributed by a corporation with respect to its stock is the date of the distribution.

(c) *Aggregation of debt instruments*—(1) *General rule.* Except as provided in paragraph (c)(2) of this section, debt instruments issued in connection with the same transaction or related transactions (determined based on all the facts and circumstances) are treated as a single debt instrument for purposes of sections 1271 through 1275 and the regulations thereunder. This rule ordinarily applies only to debt instruments of a single issuer that are issued to a single holder. The Commissioner may,

however, aggregate debt instruments that are issued by more than one issuer or that are issued to more than one holder if the debt instruments are issued in an arrangement that is designed to avoid the aggregation rule (e.g., debt instruments issued by or to related parties or debt instruments originally issued to different holders with the understanding that the debt instruments will be transferred to a single holder).

(2) *Exception if separate issue price established*. Paragraph (c)(1) of this section does not apply to a debt instrument if—

(i) The debt instrument is part of an issue a substantial portion of which is traded on an established market within the meaning of § 1.1273–2(f); or

(ii) The debt instrument is part of an issue a substantial portion of which is issued for money (or for property traded on an established market within the meaning of § 1.1273–2(f)) to parties who are not related to the issuer or holder and who do not purchase other debt instruments of the same issuer in connection with the same transaction or related transactions.

(3) *Special rule for debt instruments that provide for the issuance of additional debt instruments*. If, under the terms of a debt instrument (the original debt instrument), the holder may receive one or more additional debt instruments of the issuer, the additional debt instrument or instruments are aggregated with the original debt instrument. Thus, the payments made pursuant to an additional debt instrument are treated as made on the original debt instrument, and the distribution by the issuer of the additional debt instrument is not considered to be a payment made on the original debt instrument. This paragraph (c)(3) applies regardless of whether the right to receive an additional debt instrument is fixed as of the issue date or is contingent upon subsequent events. See § 1.1272–1(c) for the treatment of certain rights to issue additional debt instruments in lieu of cash payments.

(4) *Examples*. The following examples illustrate the rules set forth in paragraphs (c)(1) and (c)(2) of this section.

Example 1. Exception for debt instruments issued separately to other purchasers. On January 1, 1995, Corporation M issues two series of bonds, Series A and Series B. The two series are sold for cash and have different terms. Although some holders purchase bonds from both series, a substantial portion of the bonds is issued to different holders. H purchases bonds from both series. Under the exception in paragraph (c)(2)(ii) of this section, the Series A and Series B bonds purchased by H are not aggregated.

Example 2. Tiered REMICs. Z forms a dual tier real estate mortgage investment conduit (REMIC). In the dual tier structure, Z forms REMIC A to acquire a pool of real estate mortgages and to issue a residual interest and several classes of regular interests. Contemporaneously, Z forms REMIC B to acquire as qualified mortgages all of the regular interests in REMIC A. REMIC B issues several classes of regular interests and a residual interest, and Z sells all of those interests to unrelated parties in a public offering. Under the general rule set out in paragraph (c)(1) of this section, all of the regular interests issued by REMIC A and held by REMIC B are treated as a single debt instrument for purposes of sections 1271 through 1275.

(d) *Special rules for Treasury securities*—(1) *Issue price and issue date*. The issue price of an issue of Treasury securities is the average price of the securities sold. The issue date of an issue of Treasury securities is the first settlement date on which a substantial amount of the securities in the issue is sold. For an issue of Treasury securities sold from November 1, 1998, to March 13, 2001, the issue price of the issue is the price of the securities sold at auction.

(2) *Reopenings of Treasury securities*—(i) *Treatment of additional Treasury securities*. Notwithstanding § 1.1275–1(f), additional Treasury securities issued in a qualified reopening are part of the same issue as the original Treasury securities. As a result, the additional Treasury securities have the same issue price, issue date, and (with respect to holders) the same adjusted issue price as the original Treasury securities. This paragraph (d)(2) applies to qualified reopenings that occur on or after March 25, 1992.

(ii) *Definitions*—(A) *Additional Treasury securities*. Additional Treasury securities are Treasury securities with terms that are in all respects identical to the terms of the original Treasury securities.

(B) *Original Treasury securities*. Original Treasury securities are securities

comprising any issue of outstanding Treasury securities.

(C) *Qualified reopening—reopenings on or after March 13, 2001.* For a reopening of Treasury securities that occurs on or after March 13, 2001, a qualified reopening is a reopening that occurs not more than one year after the original Treasury securities were first issued to the public or, under paragraph (k)(3)(iii) of this section, a reopening in which the additional Treasury securities are issued with no more than a de minimis amount of OID. For a reopening of Treasury securities that occurs on or after September 13, 2012, a qualified reopening also is a reopening of Treasury securities that is described in paragraph (k)(3)(v) of this section.

(D) *Qualified reopening—reopenings before March 13, 2001.* For a reopening of Treasury securities that occurs before March 13, 2001, a qualified reopening is a reopening that occurs not more than one year after the original Treasury securities were first issued to the public. However, for a reopening of Treasury securities (other than Treasury Inflation-Indexed Securities) that occurred prior to November 5, 1999, a qualified reopening is a reopening of Treasury securities that satisfied the preceding sentence and that was intended to alleviate an acute, protracted shortage of the original Treasury securities.

(e) *Disclosure of certain information to holders.* Certain provisions of the regulations under section 163(e) and sections 1271 through 1275 provide that the issuer's determination of an item controls the holder's treatment of the item. In such a case, the issuer must provide the relevant information to the holder in a reasonable manner. For example, the issuer may provide the name or title and either the address or telephone number of a representative of the issuer who will make available to holders upon request the information required for holders to comply with these provisions of the regulations.

(f) *Treatment of pro rata prepayments*—(1) *Treatment as retirement of separate debt instrument.* A pro rata prepayment is treated as a payment in retirement of a portion of a debt instrument, which may result in a gain or loss to the holder. Generally, the gain or loss is calculated by assuming that the original debt instrument consists of two instruments, one that is retired and one that remains outstanding. The adjusted issue price, holder's adjusted basis, and accrued but unpaid OID of the original debt instrument, determined immediately before the pro rata prepayment, are allocated between these two instruments based on the portion of the instrument that is treated as retired by the pro rata prepayment.

(2) *Definition of pro rata prepayment.* For purposes of paragraph (f)(1) of this section, a pro rata prepayment is a payment on a debt instrument made prior to maturity that—

(i) Is not made pursuant to the instrument's payment schedule (including a payment schedule determined under § 1.1272–1(c)); and

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

(g) *Anti-abuse rule*—(1) *In general.* If a principal purpose in structuring a debt instrument or engaging in a transaction is to achieve a result that is unreasonable in light of the purposes of section 163(e), sections 1271 through 1275, or any related section of the Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable result. For example, if this paragraph (g) applies to a debt instrument that provides for a contingent payment, the Commissioner can treat the contingency as if it were a separate position. See also § 1.988–2(b)(18) for debt instruments with payments denominated in (or determined by reference to) a currency other than the taxpayer's functional currency.

(2) *Unreasonable result.* Whether a result is unreasonable is determined based on all the facts and circumstances. In making this determination, a significant fact is whether the treatment of the debt instrument is expected to have a substantial effect on the issuer's or a holder's U.S. tax liability. In the case of a contingent payment debt instrument, another significant fact is whether the result is obtainable without the application of § 1.1275–4 and any related provisions

(e.g., if the debt instrument and the contingency were entered into separately). A result will not be considered unreasonable, however, in the absence of an expected substantial effect on the present value of a taxpayer's tax liability.

(3) *Examples*. The following examples illustrate the provisions of this paragraph (g):

Example 1. A issues a current-pay, increasing-rate note that provides for an early call option. Although the option is deemed exercised on the call date under §1.1272–1(c)(5), the option is not expected to be exercised by A. In addition, a principal purpose of including the option in the terms of the note is to limit the amount of interest income includible by the holder in the period prior to the call date by virtue of the option rules in §1.1272–1(c)(5). Moreover, the application of the option rules is expected to substantially reduce the present value of the holder's tax liability. Based on these facts, the application of §1.1272–1(c)(5) produces an unreasonable result. Therefore, under this paragraph (g), the Commissioner can apply the regulations (in whole or in part) to the note without regard to §1.1272–1(c)(5).

Example 2. C, a foreign corporation not subject to U.S. taxation, issues to a U.S. holder a debt instrument that provides for a contingent payment. The debt instrument is issued for cash and is subject to the noncontingent bond method in §1.1275–4(b). Six months after issuance, C and the holder modify the debt instrument so that there is a deemed reissuance of the instrument under section 1001. The new debt instrument is subject to the rules of §1.1275–4(c) rather than §1.1275–4(b). The application of §1.1275–4(c) is expected to substantially reduce the present value of the holder's tax liability as compared to the application of §1.1275–4(b). In addition, a principal purpose of the modification is to substantially reduce the present value of the holder's tax liability through the application of §1.1275–4(c). Based on these facts, the application of §1.1275–4(c) produces an unreasonable result. Therefore, under this paragraph (g), the Commissioner can apply the noncontingent bond method to the modified debt instrument.

Example 3. D issues a convertible debt instrument rather than an economically equivalent investment unit consisting of a debt instrument and a warrant. The convertible debt instrument is issued at par and provides for annual payments of interest. D issues the convertible debt instrument rather than the investment unit so that the debt instrument would not have OID. See §1.1273–2(j). In general, this is a reasonable result in light of the purposes of the applicable statutes. Therefore, the Commissioner generally will not use the authority under this paragraph (g) to depart from the application of §1.1273-2(j) in this case.

(4) *Effective date*. This paragraph (g) applies to debt instruments issued on or after August 13, 1996.

(h) *Remote and incidental contingencies*—(1) *In general*. This paragraph (h) applies to a debt instrument if one or more payments on the instrument are subject to either a remote or incidental contingency. Whether a contingency is remote or incidental is determined as of the issue date of the debt instrument, including any date there is a deemed reissuance of the debt instrument under paragraph (h)(6) (ii) or (j) of this section or §1.1272–1(c)(6). Except as otherwise provided, the treatment of the contingency under this paragraph (h) applies for all purposes of sections 163(e) (other than sections 163(e)(5)) and 1271 through 1275 and the regulations thereunder. For purposes of this paragraph (h), the possibility of impairment of a payment by insolvency, default, or similar circumstances is not a contingency.

(2) *Remote contingencies*. A contingency is remote if there is a remote likelihood either that the contingency will occur or that the contingency will not occur. If there is a remote likelihood that the contingency will occur, it is assumed that the contingency will not occur. If there is a remote likelihood that the contingency will not occur, it is assumed that the contingency will occur.

(3) *Incidental contingencies*—(i) *Contingency relating to amount*. A contingency relating to the amount of a payment is incidental if, under all reasonably expected market conditions, the potential amount of the payment is insignificant relative to the total expected amount of the remaining payments on the debt instrument. If a payment on a debt instrument is subject to an incidental contingency described in this paragraph (h)(3)(i), the payment is ignored until the payment is made. However, see paragraph (h)(6)(i)(B) of this section for the treatment of the debt instrument if a change in circumstances occurs prior to the date the payment is made.

(ii) *Contingency relating to time*. A contingency relating to the timing of a

payment is incidental if, under all reasonably expected market conditions, the potential difference in the timing of the payment (from the earliest date to the latest date) is insignificant. If a payment on a debt instrument is subject to an incidental contingency described in this paragraph (h)(3)(ii), the payment is treated as made on the earliest date that the payment could be made pursuant to the contingency. If the payment is not made on this date, a taxpayer makes appropriate adjustments to take into account the delay in payment. However, see paragraph (h)(6)(i)(C) of this section for the treatment of the debt instrument if the delay is not insignificant.

(4) *Aggregation rule.* For purposes of paragraph (h)(2) of this section, if a debt instrument provides for multiple contingencies each of which has a remote likelihood of occurring but, when all of the contingencies are considered together, there is a greater than remote likelihood that at least one of the contingencies will occur, none of the contingencies is treated as a remote contingency. For purposes of paragraph (h)(3)(i) of this section, if a debt instrument provides for multiple contingencies each of which is incidental but the potential total amount of all of the payments subject to the contingencies is not, under reasonably expected market conditions, insignificant relative to the total expected amount of the remaining payments on the debt instrument, none of the contingencies is treated as incidental.

(5) *Consistency rule.* For purposes of paragraphs (h) (2) and (3) of this section, the issuer's determination that a contingency is either remote or incidental is binding on all holders. However, the issuer's determination is not binding on a holder that explicitly discloses that its determination is different from the issuer's determination. Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed Federal income tax return for the taxable year that includes the acquisition date of the debt instrument. See §1.1275–2(e) for rules relating to the issuer's obligation to disclose certain information to holders.

(6) *Subsequent adjustments*—(i) Applicability. This paragraph (h)(6) applies to a debt instrument when there is a change in circumstances. For purposes of the preceding sentence, there is a change in circumstances if—

(A) A remote contingency actually occurs or does not occur, contrary to the assumption made in paragraph (h)(2) of this section;

(B) A payment subject to an incidental contingency described in paragraph (h)(3)(i) of this section becomes fixed in an amount that is not insignificant relative to the total expected amount of the remaining payments on the debt instrument; or

(C) A payment subject to an incidental contingency described in paragraph (h)(3)(ii) of this section becomes fixed such that the difference between the assumed payment date and the due date of the payment is not insignificant.

(ii) *In general.* If a change in circumstances occurs, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the change in circumstances for an amount equal to the instrument's adjusted issue price on that date.

(iii) *Contingent payment debt instruments.* Notwithstanding paragraph (h)(6)(ii) of this section, in the case of a contingent payment debt instrument subject to §1.1275–4, if a change in circumstances occurs, no retirement or reissuance is treated as occurring, but any payment that is fixed as a result of the change in circumstances is governed by the rules in §1.1275–4 that apply when the amount of a contingent payment becomes fixed.

(7) *Effective date.* This paragraph (h) applies to debt instruments issued on or after August 13, 1996.

(i) [Reserved]

(j) *Treatment of certain modifications.* If the terms of a debt instrument are modified to defer one or more payments, and the modification does not cause an exchange under section 1001, then, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the modification for an amount equal to the instrument's adjusted issue price on that date. This

paragraph (j) applies to debt instruments issued on or after August 13, 1996.

(k) *Reopenings*—(1) *In general*. Notwithstanding §1.1275–1(f), additional debt instruments issued in a qualified reopening are part of the same issue as the original debt instruments. As a result, the additional debt instruments have the same issue date, the same issue price, and (with respect to holders) the same adjusted issue price as the original debt instruments.

(2) *Definitions*—(i) *Original debt instruments*. Original debt instruments are debt instruments comprising any single issue of outstanding debt instruments. For purposes of determining whether a particular reopening is a qualified reopening, debt instruments issued in prior qualified reopenings are treated as original debt instruments and debt instruments issued in the particular reopening are not so treated.

(ii) *Additional debt instruments*. Additional debt instruments are debt instruments that, without the application of this paragraph (k)—

(A) Are part of a single issue of debt instruments;

(B) Are not part of the same issue as the original debt instruments; and

(C) Have terms that are in all respects identical to the terms of the original debt instruments as of the reopening date.

(iii) *Reopening date*. The reopening date is the issue date of the additional debt instruments (determined without the application of this paragraph (k)).

(iv) *Announcement date*. The announcement date is the later of seven days before the date on which the price of the additional debt instruments is established or the date on which the issuer's intent to reopen a security is publicly announced through one or more media, including an announcement reported on the standard electronic news services used by security broker-dealers (for example, Reuters, Telerate, or Bloomberg).

(3) *Qualified reopening*—(i) *Definition*. A qualified reopening is a reopening of original debt instruments that is described in paragraph (k)(3)(ii), (k)(3)(iii), (k)(3)(iv), or (k)(3)(v) of this section. In addition, see paragraph (d)(2) of this section to determine if a reopening of Treasury securities is a qualified reopening.

(ii) *Reopening within six months*. A reopening is described in this paragraph (k)(3)(ii) if—

(A) The original debt instruments are publicly traded (within the meaning of §1.1273–2(f)) as of the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date);

(B) The reopening date of the additional debt instruments is not more than six months after the issue date of the original debt instruments; and

(C) On the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date), the yield of the original debt instruments (based on their fair market value) is not more than 110 percent of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with no more than a de minimis amount of OID, the coupon rate).

(iii) *Reopening with de minimis OID*. A reopening (including a reopening of Treasury securities) is described in this paragraph (k)(3)(iii) if—

(A) The original debt instruments are publicly traded (within the meaning of §1.1273–2(f)) as of the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date); and

(B) The additional debt instruments are issued with no more than a de minimis amount of OID (determined without the application of this paragraph (k)).

(iv) *Non-publicly traded debt issued for cash*. A reopening is described in this paragraph (k)(3)(iv) if the additional debt instruments are issued for cash to persons unrelated to the issuer (as determined under section 267(b) or 707(b)) for an arm's length price and either the requirements in paragraphs (k)(3)(ii)(B) and (k)(3)(ii)(C) of this section for a reopening within six months are satisfied or the requirements in paragraph (k)(3)(iii)(B) of this section for a reopening with de minimis OID are satisfied. For purposes of paragraph (k)(3)(ii)(C) of this section, the yield test is satisfied if, on the date on which the price of the additional debt instruments is established (or, if earlier, the

announcement date), the yield of the additional debt instruments (based on their cash purchase price) is not more than 110 percent of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with no more than a de minimis amount of OID, the coupon rate).

(v) *100 Percent yield test for reopening after six months.* A reopening is described in this paragraph (k)(3)(v) if the additional debt instruments are issued more than six months after the issue date of the original debt instruments and either the requirements in paragraphs (k)(3)(ii)(A) and (k)(3)(ii)(C) of this section are satisfied or the additional debt instruments are issued for cash to persons unrelated to the issuer (as determined under section 267(b) or 707(b)) for an arm's length price and the requirements in paragraph (k)(3)(ii)(C) of this section are satisfied. For purposes of the preceding sentence, the yield test in paragraph (k)(3)(ii)(C) of this section is satisfied if, on the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date), the yield of the additional debt instruments (based on their fair market value or cash purchase price, whichever is applicable) is not more than 100 percent of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with no more than a de minimis amount of OID, the coupon rate).

(vi) *Exceptions.* This paragraph (k)(3) does not apply to a reopening of tax-exempt obligations (as defined in section 1275(a)(3)) or contingent payment debt instruments (within the meaning of § 1.1275–4).

(4) *Issuer's treatment of a qualified reopening.* See § 1.163–7(e) for the issuer's treatment of the debt instruments that are part of a qualified reopening.

(5) *Effective/applicability dates*—(i) Except as provided in paragraph (k)(5)(ii) of this section, this paragraph (k) applies to debt instruments that are part of a reopening if the reopening date is on or after March 13, 2001.

(ii) Paragraphs (k)(3)(ii)(A), (k)(3)(iii)(A), (k)(3)(iv) and (k)(3)(v) of this section apply to debt instruments that are part of a reopening if the reopening date is on or after September 13, 2012.

(l) *OID rule for income item subject to section 451(b)*—(1) *In general.* Notwithstanding any other rule in sections 1271 through 1275 and §§ 1.1271–1 through 1.1275–7, if, and to the extent, a taxpayer's item of income with respect to a debt instrument is subject to the timing rules in § 1.451–3 because the item of income is a specified fee described in § 1.451–3(j) (such as credit card late fees, credit card cash advance fees, or interchange fees), then the taxpayer does not take the item into account to determine whether the debt instrument has any OID. As a result, the taxpayer does not treat the item as creating or increasing any OID on the debt instrument.

(2) *Applicability dates*—(i) *In general.* Except as provided in paragraph (l)(2)(ii) and (iii) of this section, for a specified credit card fee as defined in § 1.451–3(j)(2), paragraph (l)(1) of this section applies for taxable years beginning on or after January 1, 2021, and, for a specified fee that is not a specified credit card fee, paragraph (l)(1) of this section applies for taxable years beginning on or after January 6, 2022.

(ii) *Early application.* For a taxable year beginning after December 31, 2018, and before January 1, 2021, a taxpayer and its related parties, within the meaning of sections 267(b) and 707(b), may choose to apply both paragraph (l)(1) of this section and the rules in § 1.451–3, in their entirety and in a consistent manner, to all specified credit card fees subject to § 1.451–3, provided that once applied to a taxable year the rules in paragraph (l)(1) of this section and the rules in § 1.451–3 that apply to specified credit card fees, are applied in their entirety and in a consistent manner for all subsequent taxable years. See section 7508(b)(7).

(iii) *Applicability date for accounting method changes.* Paragraph (l)(1) of this section will not apply in applying section 13221(e) of Public Law 115–97, 131 Stat. 2054 (2017), to determine the section 481(a) adjustment period for any adjustment under section 481(a) for a

qualified change in method of accounting required under section 451(b) and § 1.451–3 for a specified credit card fee.

[T.D. 8517, 59 FR 4826, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30142, June 14, 1996; T.D. 8840, 64 FR 60343, Nov. 5, 1999; T.D. 8934, 66 FR 2816, Jan. 12, 2001; T.D. 9157, 69 FR 52829, Aug. 30, 2004; T.D. 9599, 77 FR 56538, Sept. 13, 2012; T.D. 9941, 86 FR 862, Jan. 6, 2021; 86 FR 1256, Jan. 8, 2021; 86 FR 2974, Jan. 14, 2021]

§ 1.1275–3 OID information reporting requirements.

(a) *In general*. This section provides legending and information reporting requirements intended to facilitate the reporting of OID.

(b) *Information required to be set forth on face of debt instruments that are not publicly offered*—(1) *In general*. Except as provided in paragraph (b)(4) or paragraph (d) of this section, this paragraph (b) applies to any debt instrument that is not publicly offered (within the meaning of § 1.1275–1(h)), is issued in physical form, and has OID. The issuer of any such debt instrument must legend the instrument by stating on the face of the instrument that the debt instrument was issued with OID. In addition, the issuer must either—

(i) Set forth on the face of the debt instrument the issue price, the amount of OID, the issue date, the yield to maturity, and, in the case of a debt instrument subject to the rules of § 1.1275–4(b), the comparable yield and projected payment schedule; or

(ii) Provide the name or title and either the address or telephone number of a representative of the issuer who will, beginning no later than 10 days after the issue date, promptly make available to holders upon request the information described in paragraph (b)(1)(i) of this section.

(2) *Time for legending*. An issuer may satisfy the requirements of this paragraph (b) by legending the debt instrument when it is first issued in physical form. Legending is not required, however, before the first holder of the debt instrument disposes of the instrument.

(3) *Legend must survive reissuance upon transfer*. Any new physical security that is issued (for example, upon registration of transfer of ownership) must contain any required legend.

(4) *Exceptions*. Paragraph (b)(1) of this section does not apply to debt instruments described in section 1272(a)(2) (relating to debt instruments not subject to the periodic OID inclusion rules), debt instruments issued by natural persons (as defined in § 1.6049–4(f)(2)), REMIC regular interests or other debt instruments subject to section 1272(a)(6), or stripped bonds and coupons within the meaning of section 1286.

(c) *Information required to be reported to Secretary upon issuance of publicly offered debt instruments*—(1) *In general*. Except as provided in paragraph (c)(3) or paragraph (d) of this section, the information reporting requirements of this paragraph (c) apply to any debt instrument that is publicly offered and has original issue discount. The issuer of any such debt instrument must make an information return on the form prescribed by the Commissioner (Form 8281, as of September 2, 1992). The prescribed form must be filed with the Internal Revenue Service in the manner specified on the form. The taxpayer must use the prescribed form even if other information returns are filed using other methods (e.g., electronic media), unless the Commissioner announces otherwise in a revenue procedure.

(2) *Time for filing information return*. The prescribed form must be filed for each issue of publicly offered debt instruments within 30 days after the issue date of the issue.

(3) *Exceptions*. The rules of paragraph (c)(1) of this section do not apply to debt instruments described in section 1272(a)(2), debt instruments issued by natural persons (as defined in § 1.6049–4(f)(2)), certificates of deposit, REMIC regular interests or other debt instruments subject to section 1272(a)(6), or (unless otherwise required by the Commissioner pursuant to a revenue ruling or revenue procedure) stripped bonds and coupons (within the meaning of section 1286).

(4) *Subsequent registration*. Except as provided in paragraph (c)(3) or (d) of this section, the information reporting requirements of paragraph (c)(1) of this section apply to any debt instrument that has original issue discount if the

instrument is part of an issue the offering of which is registered with the Securities and Exchange Commission (SEC) after the issue date of the debt instrument. For example, this paragraph (c)(4) applies to a newly issued debt instrument (B bond) exchanged for an otherwise identical non-SEC-registered debt instrument (A bond) if the B bond is part of an issue the offering of which is registered with the SEC and the B bond has an issue date that is the same as the issue date of the A bond for federal tax purposes because the exchange is not a realization event under §1.1001–3. If a debt instrument is subject to this paragraph (c)(4), the prescribed form (Form 8281 or any successor) must be filed with the Internal Revenue Service within 30 days after the date the offering is registered with the SEC. This paragraph (c)(4) applies to a debt instrument that is part of an issue the offering of which is registered with the SEC on or after January 1, 2014.

(d) *Application to foreign issuers and U.S. issuers of foreign-targeted debt instruments.* A foreign or domestic issuer is subject to the rules of this section with respect to an issue of debt instruments unless the issue is not offered for sale or resale in the United States in connection with its original issuance.

(e) *Penalties.* See section 6706 for rules relating to the penalty imposed for failure to meet the information reporting requirements imposed by this section.

(f) *Effective date.* Paragraphs (c), (d), and (e) of this section are effective for an issue of debt instruments issued after September 2, 1992.

[T.D. 8431, 57 FR 40322, Sept. 3, 1992; 57 FR 46243, Oct. 7, 1992, as amended by T.D. 8517, 59 FR 4827, Feb. 2, 1994; T.D. 8674, 61 FR 30143, June 14, 1996; T.D. 9616, 78 FR 23126, Apr. 18, 2013]

§ 1.1275–4 Contingent payment debt instruments.

(a) *Applicability*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, this section applies to any debt instrument that provides for one or more contingent payments. In general, paragraph (b) of this section applies to a contingent payment debt instrument that is issued for money or publicly traded property and paragraph (c) of this section applies to a contingent payment debt instrument that is issued for nonpublicly traded property. Paragraph (d) of this section provides special rules for tax-exempt obligations. See §1.1275–6 for a taxpayer's treatment of a contingent payment debt instrument and a hedge.

(2) *Exceptions.* This section does not apply to—

(i) A debt instrument that has an issue price determined under section 1273(b)(4) (e.g., a debt instrument subject to section 483);

(ii) A variable rate debt instrument (as defined in §1.1275–5);

(iii) A debt instrument subject to §1.1272–1(c) (a debt instrument that provides for certain contingencies) or §1.1272–1(d) (a debt instrument that provides for a fixed yield);

(iv) A debt instrument subject to section 988 (except as provided in §1.988–6);

(v) A debt instrument to which section 1272(a)(6) applies (certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration);

(vi) A debt instrument (other than a tax-exempt obligation) described in section 1272(a)(2) (e.g., U.S. savings bonds, certain loans between natural persons, and short-term taxable obligations);

(vii) An inflation-indexed debt instrument (as defined in §1.1275–7); or

(viii) A debt instrument issued pursuant to a plan or arrangement if—

(A) The plan or arrangement is created by a state statute;

(B) A primary objective of the plan or arrangement is to enable the participants to pay for the costs of post-secondary education for themselves or their designated beneficiaries; and

(C) Contingent payments on the debt instrument are related to such objective.

(3) *Insolvency and default.* A payment is not contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances.

(4) *Convertible debt instruments.* A debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt

instrument into the stock of the issuer, into the stock or debt of a related party (within the meaning of section 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt. For debt instruments issued on or after February 5, 2013, the term *stock* in the preceding sentence means an equity interest in any entity that is classified, for Federal tax purposes, as either a partnership or a corporation.

(5) *Remote and incidental contingencies.* A payment is not a contingent payment merely because of a contingency that, as of the issue date, is either remote or incidental. See § 1.1275–2(h) for the treatment of remote and incidental contingencies.

(b) *Noncontingent bond method*—(1) *Applicability.* The noncontingent bond method described in this paragraph (b) applies to a contingent payment debt instrument that has an issue price determined under § 1.1273–2 (e.g., a contingent payment debt instrument that is issued for money or publicly traded property).

(2) *In general.* Under the noncontingent bond method, interest on a debt instrument must be taken into account whether or not the amount of any payment is fixed or determinable in the taxable year. The amount of interest that is taken into account for each accrual period is determined by constructing a projected payment schedule for the debt instrument and applying rules similar to those for accruing OID on a noncontingent debt instrument. If the actual amount of a contingent payment is not equal to the projected amount, appropriate adjustments are made to reflect the difference.

(3) *Description of method.* The following steps describe how to compute the amount of income, deductions, gain, and loss under the noncontingent bond method:

(i) *Step one: Determine the comparable yield.* Determine the comparable yield for the debt instrument under the rules of paragraph (b)(4) of this section. The comparable yield is determined as of the debt instrument's issue date.

(ii) *Step two: Determine the projected payment schedule.* Determine the projected payment schedule for the debt instrument under the rules of paragraph (b)(4) of this section. The projected payment schedule is determined as of the issue date and remains fixed throughout the term of the debt instrument (except under paragraph (b)(9)(ii) of this section, which applies to a payment that is fixed more than 6 months before it is due).

(iii) *Step three: Determine the daily portions of interest.* Determine the daily portions of interest on the debt instrument for a taxable year as follows. The amount of interest that accrues in each accrual period is the product of the comparable yield of the debt instrument (properly adjusted for the length of the accrual period) and the debt instrument's adjusted issue price at the beginning of the accrual period. See paragraph (b)(7)(ii) of this section to determine the adjusted issue price of the debt instrument. The daily portions of interest are determined by allocating to each day in the accrual period the ratable portion of the interest that accrues in the accrual period. Except as modified by paragraph (b)(3)(iv) of this section, the daily portions of interest are includible in income by a holder for each day in the holder's taxable year on which the holder held the debt instrument and are deductible by the issuer for each day during the issuer's taxable year on which the issuer was primarily liable on the debt instrument.

(iv) *Step four: Adjust the amount of income or deductions for differences between projected and actual contingent payments.* Make appropriate adjustments to the amount of income or deductions attributable to the debt instrument in a taxable year for any differences between projected and actual contingent payments. See paragraph (b)(6) of this section to determine the amount of an adjustment and the treatment of the adjustment.

(4) *Comparable yield and projected payment schedule.* This paragraph (b)(4) provides rules for determining the comparable yield and projected payment schedule for a debt instrument. The comparable yield and projected payment schedule must be supported by contemporaneous documentation showing that both are reasonable, are based on reliable, complete, and accurate data, and are made in good faith.

(i) *Comparable yield*—(A) *In general.* Except as provided in paragraph (b)(4)(i)(B) of this section, the comparable yield for a debt instrument is the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument (the comparable fixed rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions. For example, if a §1.1275–6 hedge (or the substantial equivalent) is available, the comparable yield is the yield on the synthetic fixed rate debt instrument that would result if the issuer entered into the §1.1275–6 hedge. If a §1.1275–6 hedge (or the substantial equivalent) is not available, but similar fixed rate debt instruments of the issuer trade at a price that reflects a spread above a benchmark rate, the comparable yield is the sum of the value of the benchmark rate on the issue date and the spread. In determining the comparable yield, no adjustments are made for the riskiness of the contingencies or the liquidity of the debt instrument. The comparable yield must be a reasonable yield for the issuer and must not be less than the applicable Federal rate (based on the overall maturity of the debt instrument).

(B) *Presumption for certain debt instruments.* This paragraph (b)(4)(i)(B) applies to a debt instrument if the instrument provides for one or more contingent payments not based on market information and the instrument is part of an issue that is marketed or sold in substantial part to persons for whom the inclusion of interest under this paragraph (b) is not expected to have a substantial effect on their U.S. tax liability. If this paragraph (b)(4)(i)(B) applies to a debt instrument, the instrument's comparable yield is presumed to be the applicable Federal rate (based on the overall maturity of the debt instrument). A taxpayer may overcome this presumption only with clear and convincing evidence that the comparable yield for the debt instrument should be a specific yield (determined using the principles in paragraph (b)(4)(i)(A) of this section) that is higher than the applicable Federal rate. The presumption may not be overcome with appraisals or other valuations of nonpublicly traded property. Evidence used to overcome the presumption must be specific to the issuer and must not be based on comparable issuers or general market conditions.

(ii) *Projected payment schedule.* The projected payment schedule for a debt instrument includes each noncontingent payment and an amount for each contingent payment determined as follows:

(A) *Market-based payments.* If a contingent payment is based on market information (a market-based payment), the amount of the projected payment is the forward price of the contingent payment. The forward price of a contingent payment is the amount one party would agree, as of the issue date, to pay an unrelated party for the right to the contingent payment on the settlement date (e.g., the date the contingent payment is made). For example, if the right to a contingent payment is substantially similar to an exchange-traded option, the forward price is the spot price of the option (the option premium) compounded at the applicable Federal rate from the issue date to the date the contingent payment is due.

(B) *Other payments.* If a contingent payment is not based on market information (a non-market-based payment), the amount of the projected payment is the expected value of the contingent payment as of the issue date.

(C) *Adjustments to the projected payment schedule.* The projected payment schedule must produce the comparable yield. If the projected payment schedule does not produce the comparable yield, the schedule must be adjusted consistent with the principles of this paragraph (b)(4) to produce the comparable yield. For example, the adjusted amounts of non-market-based payments must reasonably reflect the relative expected values of the payments and must not be set to accelerate or defer income or deductions. If the debt instrument contains both market-based and non-market-based payments, adjustments are generally made first to the non-market-based payments because more objective information is available for the market-based payments.

(iii) *Market information*. For purposes of this paragraph (b), market information is any information on which an objective rate can be based under § 1.1275–5(c) (1) or (2).

(iv) *Issuer/holder consistency*. The issuer's projected payment schedule is used to determine the holder's interest accruals and adjustments. The issuer must provide the projected payment schedule to the holder in a manner consistent with the issuer disclosure rules of § 1.1275–2(e). If the issuer does not create a projected payment schedule for a debt instrument or the issuer's projected payment schedule is unreasonable, the holder of the debt instrument must determine the comparable yield and projected payment schedule for the debt instrument under the rules of this paragraph (b)(4). A holder that determines its own projected payment schedule must explicitly disclose this fact and the reason why the holder set its own schedule (e.g., why the issuer's projected payment schedule is unreasonable). Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed Federal income tax return for the taxable year that includes the acquisition date of the debt instrument.

(v) *Issuer's determination respected*—(A) *In general*. If the issuer maintains the contemporaneous documentation required by this paragraph (b)(4), the issuer's determination of the comparable yield and projected payment schedule will be respected unless either is unreasonable.

(B) *Unreasonable determination*. For purposes of paragraph (b)(4)(v)(A) of this section, a comparable yield or projected payment schedule generally will be considered unreasonable if it is set with a purpose to overstate, understate, accelerate, or defer interest accruals on the debt instrument. In a determination of whether a comparable yield or projected payment schedule is unreasonable, consideration will be given to whether the treatment of the debt instrument under this section is expected to have a substantial effect on the issuer's or holder's U.S. tax liability. For example, if a taxable issuer markets a debt instrument to a holder not subject to U.S. taxation, the comparable yield will be given close scrutiny and will not be respected unless contemporaneous documentation shows that the yield is not too high.

(C) *Exception*. Paragraph (b)(4)(v)(A) of this section does not apply to a debt instrument subject to paragraph (b)(4)(i)(B) of this section (concerning a yield presumption for certain debt instruments that provide for non-market-based payments).

(vi) *Examples*. The following examples illustrate the provisions of this paragraph (b)(4). In each example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes.

Example 1. Market-based payment. (i) *Facts*. On December 31, 1996, X corporation issues for $1,000,000 a debt instrument that matures on December 31, 2006. The debt instrument provides for annual payments of interest, beginning in 1997, at the rate of 6 percent and for a payment at maturity equal to $1,000,000 plus the excess, if any, of the price of 10,000 shares of publicly traded stock in an unrelated corporation on the maturity date over $350,000, or less the excess, if any, of $350,000 over the price of 10,000 shares of the stock on the maturity date. On the issue date, the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $350,000.

(ii) *Comparable yield*. Under paragraph (b)(4)(i) of this section, the debt instrument's comparable yield is the yield on the synthetic debt instrument that would result if X corporation entered into a § 1.1275–6 hedge. A § 1.1275–6 hedge in this case is a forward contract to purchase 10,000 shares of the stock on December 31, 2006. If X corporation entered into this hedge, the resulting synthetic debt instrument would yield 6 percent, compounded annually. Thus, the comparable yield on the debt instrument is 6 percent, compounded annually.

(iii) *Projected payment schedule*. Under paragraph (b)(4)(ii) of this section, the projected payment schedule for the debt instrument consists of 10 annual payments of $60,000 and a projected amount for the contingent payment at maturity. Because the right to the contingent payment is based on market information, the projected amount of the contingent payment is the forward price of the payment. The right to the contingent payment is substantially similar to a right to a payment of $1,000,000 combined with a cash-settled forward contract for the purchase of 10,000 shares of the stock for $350,000 on December 31, 2006. Because the forward price to

purchase 10,000 shares of the stock on December 31, 2006, is $350,000, the amount to be received or paid under the forward contract is projected to be zero. As a result, the projected amount of the contingent payment at maturity is $1,000,000, consisting of the $1,000,000 base amount and no additional amount to be received or paid under the forward contract.

(A) Assume, alternatively, that on the issue date the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $370,000. If X corporation entered into a §1.1275–6 hedge (a forward contract to purchase the shares for $370,000), the resulting synthetic debt instrument would yield 6.15 percent, compounded annually. Thus, the comparable yield on the debt instrument is 6.15 percent, compounded annually. The projected payment schedule for the debt instrument consists of 10 annual payments of $60,000 and a projected amount for the contingent payment at maturity. The projected amount of the contingent payment is $1,020,000, consisting of the $1,000,000 base amount plus the excess $20,000 of the forward price of the stock over the purchase price of the stock under the forward contract.

(B) Assume, alternatively, that on the issue date the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $330,000. If X corporation entered into a §1.1275–6 hedge, the resulting synthetic debt instrument would yield 5.85 percent, compounded annually. Thus, the comparable yield on the debt instrument is 5.85 percent, compounded annually. The projected payment schedule for the debt instrument consists of 10 annual payments of $60,000 and a projected amount for the contingent payment at maturity. The projected amount of the contingent payment is $980,000, consisting of the $1,000,000 base amount minus the excess $20,000 of the purchase price of the stock under the forward contract over the forward price of the stock.

Example 2. Non-market-based payments. (i) *Facts.* On December 31, 1996, Y issues to Z for $1,000,000 a debt instrument that matures on December 31, 2000. The debt instrument has a stated principal amount of $1,000,000, payable at maturity, and provides for payments on December 31 of each year, beginning in 1997, of $20,000 plus 1 percent of Y's gross receipts, if any, for the year. On the issue date, Y has outstanding fixed rate debt instruments with maturities of 2 to 10 years that trade at a price that reflects an average of 100 basis points over Treasury bonds. These debt instruments have terms and conditions similar to those of the debt instrument. Assume that on December 31, 1996, 4-year Treasury bonds have a yield of 6.5 percent, compounded annually, and that no §1.1275–6 hedge is available for the debt instrument. In addition, assume that the interest inclusions attributable to the debt instrument are expected to have a substantial effect on Z's U.S. tax liability.

(ii) *Comparable yield.* The comparable yield for the debt instrument is equal to the value of the benchmark rate (i.e., the yield on 4-year Treasury bonds) on the issue date plus the spread. Thus, the debt instrument's comparable yield is 7.5 percent, compounded annually.

(iii) *Projected payment schedule.* Y anticipates that it will have no gross receipts in 1997, but that it will have gross receipts in later years, and those gross receipts will grow each year for the next three years. Based on its business projections, Y believes that it is not unreasonable to expect that its gross receipts in 1999 and each year thereafter will grow by between 6 percent and 13 percent over the prior year. Thus, Y must take these expectations into account in establishing a projected payment schedule for the debt instrument that results in a yield of 7.5 percent, compounded annually. Accordingly, Y could reasonably set the following projected payment schedule for the debt instrument:

Date	Noncontingent payment	Contingent payment
12/31/1997	$20,000	$0
12/31/1998	20,000	70,000
12/31/1999	20,000	75,600
12/31/2000	1,020,000	83,850

(5) *Qualified stated interest.* No amounts payable on a debt instrument to which this paragraph (b) applies are qualified stated interest within the meaning of §1.1273–1(c).

(6) *Adjustments.* This paragraph (b)(6) provides rules for the treatment of positive and negative adjustments under the noncontingent bond method. A taxpayer takes into account only those adjustments that occur during a taxable year while the debt instrument is held by the taxpayer or while the taxpayer is primarily liable on the debt instrument.

(i) *Determination of positive and negative adjustments.* If the amount of a contingent payment is more than the projected amount of the contingent payment, the difference is a positive adjustment on the date of the payment. If the amount of a contingent payment is less than the projected amount of the contingent payment, the difference is a negative adjustment on the date of the payment (or on the scheduled date of the payment if the amount of the payment is zero).

(ii) *Treatment of net positive adjustments*. The amount, if any, by which total positive adjustments on a debt instrument in a taxable year exceed the total negative adjustments on the debt instrument in the taxable year is a net positive adjustment. A net positive adjustment is treated as additional interest for the taxable year.

(iii) *Treatment of net negative adjustments*. The amount, if any, by which total negative adjustments on a debt instrument in a taxable year exceed the total positive adjustments on the debt instrument in the taxable year is a net negative adjustment. A taxpayer's net negative adjustment on a debt instrument for a taxable year is treated as follows:

(A) *Reduction of interest accruals*. A net negative adjustment first reduces interest for the taxable year that the taxpayer would otherwise account for on the debt instrument under paragraph (b)(3)(iii) of this section.

(B) *Ordinary income or loss*. If the net negative adjustment exceeds the interest for the taxable year that the taxpayer would otherwise account for on the debt instrument under paragraph (b)(3)(iii) of this section, the excess is treated as ordinary loss by a holder and ordinary income by an issuer. However, the amount treated as ordinary loss by a holder is limited to the amount by which the holder's total interest inclusions on the debt instrument exceed the total amount of the holder's net negative adjustments treated as ordinary loss on the debt instrument in prior taxable years. The amount treated as ordinary income by an issuer is limited to the amount by which the issuer's total interest deductions on the debt instrument exceed the total amount of the issuer's net negative adjustments treated as ordinary income on the debt instrument in prior taxable years.

(C) *Carryforward*. If the net negative adjustment exceeds the sum of the amounts treated by the taxpayer as a reduction of interest and as ordinary income or loss (as the case may be) on the debt instrument for the taxable year, the excess is a negative adjustment carryforward for the taxable year. In general, a taxpayer treats a negative adjustment carryforward for a taxable year as a negative adjustment on the debt instrument on the first day of the succeeding taxable year. However, if a holder of a debt instrument has a negative adjustment carryforward on the debt instrument in a taxable year in which the debt instrument is sold, exchanged, or retired, the negative adjustment carryforward reduces the holder's amount realized on the sale, exchange, or retirement. If an issuer of a debt instrument has a negative adjustment carryforward on the debt instrument for a taxable year in which the debt instrument is retired, the issuer takes the negative adjustment carryforward into account as ordinary income.

(D) *Treatment under section 67*. A net negative adjustment is not subject to section 67 (the 2-percent floor on miscellaneous itemized deductions).

(iv) *Cross-references*. If a holder has a basis in a debt instrument that is different from the debt instrument's adjusted issue price, the holder may have additional positive or negative adjustments under paragraph (b)(9)(i) of this section. If the amount of a contingent payment is fixed more than 6 months before the date it is due, the amount and timing of the adjustment are determined under paragraph (b)(9)(ii) of this section.

(7) *Adjusted issue price, adjusted basis, and retirement*—(i) *In general*. If a debt instrument is subject to the noncontingent bond method, this paragraph (b)(7) provides rules to determine the adjusted issue price of the debt instrument, the holder's basis in the debt instrument, and the treatment of any scheduled or unscheduled retirements. In general, because any difference between the actual amount of a contingent payment and the projected amount of the payment is taken into account as an adjustment to income or deduction, the projected payments are treated as the actual payments for purposes of making adjustments to issue price and basis and determining the amount of any contingent payment made on a scheduled retirement.

(ii) *Definition of adjusted issue price*. The adjusted issue price of a debt instrument is equal to the debt instrument's issue price, increased by the interest previously accrued on the debt

instrument under paragraph (b)(3)(iii) of this section (determined without regard to any adjustments taken into account under paragraph (b)(3)(iv) of this section), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument. See paragraph (b)(9)(ii) of this section for special rules that apply when a contingent payment is fixed more than 6 months before it is due.

(iii) *Adjustments to basis.* A holder's basis in a debt instrument is increased by the interest previously accrued by the holder on the debt instrument under paragraph (b)(3)(iii) of this section (determined without regard to any adjustments taken into account under paragraph (b)(3)(iv) of this section), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument to the holder. See paragraph (b)(9)(i) of this section for special rules that apply when basis is different from adjusted issue price and paragraph (b)(9)(ii) of this section for special rules that apply when a contingent payment is fixed more than 6 months before it is due.

(iv) *Scheduled retirements.* For purposes of determining the amount realized by a holder and the repurchase price paid by the issuer on the scheduled retirement of a debt instrument, a holder is treated as receiving, and the issuer is treated as paying, the projected amount of any contingent payment due at maturity. If the amount paid or received is different from the projected amount, see paragraph (b)(6) of this section for the treatment of the difference by the taxpayer. Under paragraph (b)(6)(iii)(C) of this section, the amount realized by a holder on the retirement of a debt instrument is reduced by any negative adjustment carryforward determined in the taxable year of the retirement.

(v) *Unscheduled retirements.* An unscheduled retirement of a debt instrument (or the receipt of a pro-rata prepayment that is treated as a retirement of a portion of a debt instrument under § 1.1275–2(f)) is treated as a repurchase of the debt instrument (or a prorata portion of the debt instrument) by the issuer from the holder for the amount paid by the issuer to the holder.

(vi) *Examples.* The following examples illustrate the provisions of paragraphs (b) (6) and (7) of this section. In each example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes.

Example 1. Treatment of positive and negative adjustments. (i) *Facts.* On December 31, 1996, Z, a calendar year taxpayer, purchases a debt instrument subject to this paragraph (b) at original issue for $1,000. The debt instrument's comparable yield is 10 percent, compounded annually, and the projected payment schedule provides for payments of $500 on December 31, 1997 (consisting of a noncontingent payment of $375 and a projected amount of $125) and $660 on December 31, 1998 (consisting of a noncontingent payment of $600 and a projected amount of $60). The debt instrument is a capital asset in the hands of Z.

(ii) *Adjustment in 1997.* Based on the projected payment schedule, Z's total daily portions of interest on the debt instrument are $100 for 1997 (issue price of $1,000 × 10 percent). Assume that the payment actually made on December 31, 1997, is $375, rather than the projected $500. Under paragraph (b)(6)(i) of this section, Z has a negative adjustment of $125 on December 31, 1997, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Because Z has no positive adjustments for 1997, Z has a net negative adjustment of $125 on the debt instrument for 1997. This net negative adjustment reduces to zero the $100 total daily portions of interest Z would otherwise include in income in 1997. Accordingly, Z has no interest income on the debt instrument for 1997. Because Z had no interest inclusions on the debt instrument for prior taxable years, the remaining $25 of the net negative adjustment is a negative adjustment carryforward for 1997 that results in a negative adjustment of $25 on January 1, 1998.

(iii) *Adjustment to issue price and basis.* Z's total daily portions of interest on the debt instrument are $100 for 1997. The adjusted issue price of the debt instrument and Z's adjusted basis in the debt instrument are increased by this amount, despite the fact that Z does not include this amount in income because of the net negative adjustment for 1997. In addition, the adjusted issue price of the debt instrument and Z's adjusted basis in the debt instrument are decreased on December 31, 1997, by the projected amount of the

payment on that date ($500). Thus, on January 1, 1998, Z's adjusted basis in the debt instrument and the adjusted issue price of the debt instrument are $600.

(iv) *Adjustments in 1998*. Based on the projected payment schedule, Z's total daily portions of interest are $60 for 1998 (adjusted issue price of $600 × 10 percent). Assume that the payment actually made on December 31, 1998, is $700, rather than the projected $660. Under paragraph (b)(6)(i) of this section, Z has a positive adjustment of $40 on December 31, 1998, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Because Z also has a negative adjustment of $25 on January 1, 1998, Z has a net positive adjustment of $15 on the debt instrument for 1998 (the excess of the $40 positive adjustment over the $25 negative adjustment). As a result, Z has $75 of interest income on the debt instrument for 1998 (the $15 net positive adjustment plus the $60 total daily portions of interest that are taken into account by Z in that year).

(v) *Retirement*. Based on the projected payment schedule, Z's adjusted basis in the debt instrument immediately before the payment at maturity is $660 ($600 plus $60 total daily portions of interest for 1998). Even though Z receives $700 at maturity, for purposes of determining the amount realized by Z on retirement of the debt instrument, Z is treated as receiving the projected amount of the contingent payment on December 31, 1998. Therefore, Z is treated as receiving $660 on December 31, 1998. Because Z's adjusted basis in the debt instrument immediately before its retirement is $660, Z recognizes no gain or loss on the retirement.

Example 2. Negative adjustment carryforward for year of sale. (i) *Facts*. Assume the same facts as in *Example 1* of this paragraph (b)(7)(vi), except that Z sells the debt instrument on January 1, 1998, for $630.

(ii) *Gain on sale*. On the date the debt instrument is sold, Z's adjusted basis in the debt instrument is $600. Because Z has a negative adjustment of $25 on the debt instrument on January 1, 1998, and has no positive adjustments on the debt instrument in 1998, Z has a net negative adjustment for 1998 of $25. Because Z has not included in income any interest on the debt instrument, the entire $25 net negative adjustment is a negative adjustment carryforward for the taxable year of the sale. Under paragraph (b)(6)(iii)(C) of this section, the $25 negative adjustment carryforward reduces the amount realized by Z on the sale of the debt instrument from $630 to $605. Thus, Z has a gain on the sale of $5 ($605 − $600). Under paragraph (b)(8)(i) of this section, the gain is treated as interest income.

Example 3. Negative adjustment carryforward for year of retirement. (i) *Facts*. Assume the same facts as in *Example 1* of this paragraph (b)(7)(vi), except that the payment actually made on December 31, 1998, is $615, rather than the projected $660.

(ii) *Adjustments in 1998*. Under paragraph (b)(6)(i) of this section, Z has a negative adjustment of $45 on December 31, 1998, attributable to the difference between the amount of the actual payment and the amount of the projected payment. In addition, Z has a negative adjustment of $25 on January 1, 1998. See *Example 1*(ii) of this paragraph (b)(7)(vi). Because Z has no positive adjustments in 1998, Z has a net negative adjustment of $70 for 1998. This net negative adjustment reduces to zero the $60 total daily portions of interest Z would otherwise include in income for 1998. Therefore, Z has no interest income on the debt instrument for 1998. Because Z had no interest inclusions on the debt instrument for 1997, the remaining $10 of the net negative adjustment is a negative adjustment carryforward for 1998 that reduces the amount realized by Z on retirement of the debt instrument.

(iii) *Loss on retirement*. Immediately before the payment at maturity, Z's adjusted basis in the debt instrument is $660. Under paragraph (b)(7)(iv) of this section, Z is treated as receiving the projected amount of the contingent payment, or $660, as the payment at maturity. Under paragraph (b)(6)(iii)(C) of this section, however, this amount is reduced by any negative adjustment carryforward determined for the taxable year of retirement to calculate the amount Z realizes on retirement of the debt instrument. Thus, Z has a loss of $10 on the retirement of the debt instrument, equal to the amount by which Z's adjusted basis in the debt instrument ($660) exceeds the amount Z realizes on the retirement of the debt instrument ($660 minus the $10 negative adjustment carryforward). Under paragraph (b)(8)(ii) of this section, the loss is a capital loss.

(8) *Character on sale, exchange, or retirement*—(i) *Gain*. Any gain recognized by a holder on the sale, exchange, or retirement of a debt instrument subject to this paragraph (b) is interest income.

(ii) *Loss*. Any loss recognized by a holder on the sale, exchange, or retirement of a debt instrument subject to this paragraph (b) is ordinary loss to the extent that the holder's total interest inclusions on the debt instrument exceed the total net negative adjustments on the debt instrument the holder took into account as ordinary loss. Any additional loss is treated as loss from the sale, exchange, or retirement of the debt instrument. However, any loss that would otherwise be ordinary under this paragraph (b)(8)(ii) and that

is attributable to the holder's basis that could not be amortized under section 171(b)(4) is loss from the sale, exchange, or retirement of the debt instrument.

(iii) *Special rule if there are no remaining contingent payments on the debt instrument*—(A) *In general.* Notwithstanding paragraphs (b)(8) (i) and (ii) of this section, if, at the time of the sale, exchange, or retirement of the debt instrument, there are no remaining contingent payments due on the debt instrument under the projected payment schedule, any gain or loss recognized by the holder is gain or loss from the sale, exchange, or retirement of the debt instrument. See paragraph (b)(9)(ii) of this section to determine whether there are no remaining contingent payments on a debt instrument that provides for fixed but deferred contingent payments.

(B) *Exception for certain positive adjustments.* Notwithstanding paragraph (b)(8)(iii)(A) of this section, if a positive adjustment on a debt instrument is spread under paragraph (b)(9)(ii) (F) or (G) of this section, any gain recognized by the holder on the sale, exchange, or retirement of the instrument is treated as interest income to the extent of the positive adjustment that has not yet been accrued and included in income by the holder.

(iv) *Examples.* The following examples illustrate the provisions of this paragraph (b)(8). In each example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes.

Example 1. Gain on sale. (i) *Facts.* On January 1, 1998, D, a calendar year taxpayer, sells a debt instrument that is subject to paragraph (b) of this section for $1,350. The projected payment schedule for the debt instrument provides for contingent payments after January 1, 1998. On January 1, 1998, D has an adjusted basis in the debt instrument of $1,200. In addition, D has a negative adjustment carryforward of $50 for 1997 that, under paragraph (b)(6)(iii)(C) of this section, results in a negative adjustment of $50 on January 1, 1998. D has no positive adjustments on the debt instrument on January 1, 1998.

(ii) *Character of gain.* Under paragraph (b)(6) of this section, the $50 negative adjustment on January 1, 1998, results in a negative adjustment carryforward for 1998, the taxable year of the sale of the debt instrument. Under paragraph (b)(6)(iii)(C) of this section, the negative adjustment carryforward reduces the amount realized by D on the sale of the debt instrument from $1,350 to $1,300. As a result, D realizes a $100 gain on the sale of the debt instrument, equal to the $1,300 amount realized minus D's $1,200 adjusted basis in the debt instrument. Under paragraph (b)(8)(i) of this section, the gain is interest income to D.

Example 2. Loss on sale. (i) *Facts.* On December 31, 1996, E, a calendar year taxpayer, purchases a debt instrument at original issue for $1,000. The debt instrument is a capital asset in the hands of E. The debt instrument provides for a single payment on December 31, 1998 (the maturity date of the instrument), of $1,000 plus an amount based on the increase, if any, in the price of a specified commodity over the term of the instrument. The comparable yield for the debt instrument is 9.54 percent, compounded annually, and the projected payment schedule provides for a payment of $1,200 on December 31, 1998. Based on the projected payment schedule, the total daily portions of interest are $95 for 1997 and $105 for 1998.

(ii) *Ordinary loss.* Assume that E sells the debt instrument for $1,050 on December 31, 1997. On that date, E has an adjusted basis in the debt instrument of $1,095 ($1,000 original basis, plus total daily portions of $95 for 1997). Therefore, E realizes a $45 loss on the sale of the debt instrument ($1,050–$1,095). The loss is ordinary to the extent E's total interest inclusions on the debt instrument ($95) exceed the total net negative adjustments on the instrument that E took into account as an ordinary loss. Because E has not had any net negative adjustments on the debt instrument, the $45 loss is an ordinary loss.

(iii) *Capital loss.* Alternatively, assume that E sells the debt instrument for $990 on December 31, 1997. E realizes a $105 loss on the sale of the debt instrument ($990 − $1,095). The loss is ordinary to the extent E's total interest inclusions on the debt instrument ($95) exceed the total net negative adjustments on the instrument that E took into account as an ordinary loss. Because E has not had any net negative adjustments on the debt instrument, $95 of the $105 loss is an ordinary loss. The remaining $10 of the $105 loss is a capital loss.

(9) *Operating rules.* The rules of this paragraph (b)(9) apply to a debt instrument subject to the noncontingent bond method notwithstanding any other rule of this paragraph (b).

(i) *Basis different from adjusted issue price.* This paragraph (b)(9)(i) provides rules for a holder whose basis in a debt

instrument is different from the adjusted issue price of the debt instrument (e.g., a subsequent holder that purchases the debt instrument for more or less than the instrument's adjusted issue price).

(A) *General rule*. The holder accrues interest under paragraph (b)(3)(iii) of this section and makes adjustments under paragraph (b)(3)(iv) of this section based on the projected payment schedule determined as of the issue date of the debt instrument. However, upon acquiring the debt instrument, the holder must reasonably allocate any difference between the adjusted issue price and the basis to daily portions of interest or projected payments over the remaining term of the debt instrument. Allocations are taken into account under paragraphs (b)(9)(i) (B) and (C) of this section.

(B) *Basis greater than adjusted issue price*. If the holder's basis in the debt instrument exceeds the debt instrument's adjusted issue price, the amount of the difference allocated to a daily portion of interest or to a projected payment is treated as a negative adjustment on the date the daily portion accrues or the payment is made. On the date of the adjustment, the holder's adjusted basis in the debt instrument is reduced by the amount the holder treats as a negative adjustment under this paragraph (b)(9)(i)(B). See paragraph (b)(9)(ii)(E) of this section for a special rule that applies when a contingent payment is fixed more than 6 months before it is due.

(C) *Basis less than adjusted issue price*. If the holder's basis in the debt instrument is less than the debt instrument's adjusted issue price, the amount of the difference allocated to a daily portion of interest or to a projected payment is treated as a positive adjustment on the date the daily portion accrues or the payment is made. On the date of the adjustment, the holder's adjusted basis in the debt instrument is increased by the amount the holder treats as a positive adjustment under this paragraph (b)(9)(i)(C). See paragraph (b)(9)(ii)(E) of this section for a special rule that applies when a contingent payment is fixed more than 6 months before it is due.

(D) *Premium and discount rules do not apply*. The rules for accruing premium and discount in sections 171, 1272(a)(7), 1276, and 1281 do not apply. Other rules of those sections, such as section 171(b)(4), continue to apply to the extent relevant.

(E) *Safe harbor for exchange listed debt instruments*. If the debt instrument is exchange listed property (within the meaning of §1.1273–2(f)(2) as contained in 26 CFR part 1, revised April 1, 2011), it is reasonable for the holder to allocate any difference between the holder's basis and the adjusted issue price of the debt instrument pro-rata to daily portions of interest (as determined under paragraph (b)(3)(iii) of this section) over the remaining term of the debt instrument. A pro-rata allocation is not reasonable, however, to the extent the holder's yield on the debt instrument, determined after taking into account the amounts allocated under this paragraph (b)(9)(i)(E), is less than the applicable Federal rate for the instrument. For purposes of the preceding sentence, the applicable Federal rate for the debt instrument is determined as if the purchase date were the issue date and the remaining term of the instrument were the term of the instrument.

(F) *Examples*. The following examples illustrate the provisions of this paragraph (b)(9)(i). In each example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes. In addition, assume that each instrument is not exchange listed property.

Example 1. Basis greater than adjusted issue price. (i) *Facts*. On July 1, 1998, Z purchases for $1,405 a debt instrument that matures on December 31, 1999, and promises to pay on the maturity date $1,000 plus the increase, if any, in the price of a specified amount of a commodity from the issue date to the maturity date. The debt instrument was originally issued on December 31, 1996, for an issue price of $1,000. The comparable yield for the debt instrument is 10.25 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date) provides for a single payment at maturity of $1,350. At

the time of the purchase, the debt instrument has an adjusted issue price of $1,162, assuming semiannual accrual periods ending on December 31 and June 30 of each year. The increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment and not to a decrease in market interest rates. The debt instrument is a capital asset in the hands of Z. Z is a calendar year taxpayer.

(ii) *Allocation of the difference between basis and adjusted issue price.* Z's basis in the debt instrument on July 1, 1998, is $1,405. Under paragraph (b)(9)(i)(A) of this section, Z allocates the $243 difference between basis ($1,405) and adjusted issue price ($1,162) to the contingent payment at maturity. Z's allocation of the difference between basis and adjusted issue price is reasonable because the increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment.

(iii) *Treatment of debt instrument for 1998.* Based on the projected payment schedule, $60 of interest accrues on the debt instrument from July 1, 1998 to December 31, 1998 (the product of the debt instrument's adjusted issue price on July 1, 1998 ($1,162) and the comparable yield properly adjusted for the length of the accrual period (10.25 percent/2)). Z has no net negative or positive adjustments for 1998. Thus, Z includes in income $60 of total daily portions of interest for 1998. On December 31, 1998, Z's adjusted basis in the debt instrument is $1,465 ($1,405 original basis, plus total daily portions of $60 for 1998).

(iv) *Effect of allocation to contingent payment at maturity.* Assume that the payment actually made on December 31, 1999, is $1,400, rather than the projected $1,350. Thus, under paragraph (b)(6)(i) of this section, Z has a positive adjustment of $50 on December 31, 1999. In addition, under paragraph (b)(9)(i)(B) of this section, Z has a negative adjustment of $243 on December 31, 1999, which is attributable to the difference between Z's basis in the debt instrument on July 1, 1998, and the instrument's adjusted issue price on that date. As a result, Z has a net negative adjustment of $193 for 1999. This net negative adjustment reduces to zero the $128 total daily portions of interest Z would otherwise include in income in 1999. Accordingly, Z has no interest income on the debt instrument for 1999. Because Z had $60 of interest inclusions for 1998, $60 of the remaining $65 net negative adjustment is treated by Z as an ordinary loss for 1999. The remaining $5 of the net negative adjustment is a negative adjustment carryforward for 1999 that reduces the amount realized by Z on the retirement of the debt instrument from $1,350 to $1,345.

(v) *Loss at maturity.* On December 31, 1999, Z's basis in the debt instrument is $1,350 ($1,405 original basis, plus total daily portions of $60 for 1998 and $128 for 1999, minus the negative adjustment of $243). As a result, Z realizes a loss of $5 on the retirement of the debt instrument (the difference between the amount realized on the retirement ($1,345) and Z's adjusted basis in the debt instrument ($1,350)). Under paragraph (b)(8)(ii) of this section, the $5 loss is treated as loss from the retirement of the debt instrument. Consequently, Z realizes a total loss of $65 on the debt instrument for 1999 (a $60 ordinary loss and a $5 capital loss).

Example 2. Basis less than adjusted issue price. (i) *Facts.* On January 1, 1999, Y purchases for $910 a debt instrument that pays 7 percent interest semiannually on June 30 and December 31 of each year, and that promises to pay on December 31, 2001, $1,000 plus or minus $10 times the positive or negative difference, if any, between a specified amount and the value of an index on December 31, 2001. However, the payment on December 31, 2001, may not be less than $650. The debt instrument was originally issued on December 31, 1996, for an issue price of $1,000. The comparable yield for the debt instrument is 9.80 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date) provides for semiannual payments of $35 and a contingent payment at maturity of $1,175. On January 1, 1999, the debt instrument has an adjusted issue price of $1,060, assuming semiannual accrual periods ending on December 31 and June 30 of each year. Y is a calendar year taxpayer.

(ii) *Allocation of the difference between basis and adjusted issue price.* Y's basis in the debt instrument on January 1, 1999, is $910. Under paragraph (b)(9)(i)(A) of this section, Y must allocate the $150 difference between basis ($910) and adjusted issue price ($1,060) to daily portions of interest or to projected payments. These amounts will be positive adjustments taken into account at the time the daily portions accrue or the payments are made.

(A) Assume that, because of a decrease in the relevant index, the expected value of the payment at maturity has declined by about 9 percent. Based on forward prices on January 1, 1999, Y determines that approximately $105 of the difference between basis and adjusted issue price is allocable to the contingent payment. Y allocates the remaining $45 to daily portions of interest on a pro-rata basis (i.e., the amount allocated to an accrual period equals the product of $45 and a fraction, the numerator of which is the total daily portions for the accrual period and the denominator of which is the total daily portions remaining on the debt instrument on January 1, 1999). This allocation is reasonable.

(B) Assume alternatively that, based on yields of comparable debt instruments and

its purchase price for the debt instrument, Y determines that an appropriate yield for the debt instrument is 13 percent, compounded semiannually. Based on this determination, Y allocates $55.75 of the difference between basis and adjusted issue price to daily portions of interest as follows: $15.19 to the daily portions of interest for the taxable year ending December 31, 1999; $18.40 to the daily portions of interest for the taxable year ending December 31, 2000; and $22.16 to the daily portions of interest for the taxable year ending December 31, 2001. Y allocates the remaining $94.25 to the contingent payment at maturity. This allocation is reasonable.

(ii) *Fixed but deferred contingent payments*. This paragraph (b)(9)(ii) provides rules that apply when the amount of a contingent payment becomes fixed before the payment is due. For purposes of paragraph (b) of this section, if a contingent payment becomes fixed within the 6-month period ending on the due date of the payment, the payment is treated as a contingent payment even after the payment is fixed. If a contingent payment becomes fixed more than 6 months before the payment is due, the following rules apply to the debt instrument.

(A) *Determining adjustments*. The amount of the adjustment attributable to the contingent payment is equal to the difference between the present value of the amount that is fixed and the present value of the projected amount of the contingent payment. The present value of each amount is determined by discounting the amount from the date the payment is due to the date the payment becomes fixed, using a discount rate equal to the comparable yield on the debt instrument. The adjustment is treated as a positive or negative adjustment, as appropriate, on the date the contingent payment becomes fixed. See paragraph (b)(9)(ii)(G) of this section to determine the timing of the adjustment if all remaining contingent payments on the debt instrument become fixed substantially contemporaneously.

(B) *Payment schedule*. The contingent payment is no longer treated as a contingent payment after the date the amount of the payment becomes fixed. On the date the contingent payment becomes fixed, the projected payment schedule for the debt instrument is modified prospectively to reflect the fixed amount of the payment. Therefore, no adjustment is made under paragraph (b)(3)(iv) of this section when the contingent payment is actually made.

(C) *Accrual period*. Notwithstanding the determination under §1.1272–1(b)(1)(ii) of accrual periods for the debt instrument, an accrual period ends on the day the contingent payment becomes fixed, and a new accrual period begins on the day after the day the contingent payment becomes fixed.

(D) *Adjustments to basis and adjusted issue price*. The amount of any positive adjustment on a debt instrument determined under paragraph (b)(9)(ii)(A) of this section increases the adjusted issue price of the instrument and the holder's adjusted basis in the instrument. Similarly, the amount of any negative adjustment on a debt instrument determined under paragraph (b)(9)(ii)(A) of this section decreases the adjusted issue price of the instrument and the holder's adjusted basis in the instrument.

(E) *Basis different from adjusted issue price*. If a holder's basis in a debt instrument exceeds the debt instrument's adjusted issue price, the amount allocated to a projected payment under paragraph (b)(9)(i) of this section is treated as a negative adjustment on the date the payment becomes fixed. If a holder's basis in a debt instrument is less than the debt instrument's adjusted issue price, the amount allocated to a projected payment under paragraph (b)(9)(i) of this section is treated as a positive adjustment on the date the payment becomes fixed.

(F) *Special rule for certain contingent interest payments*. Notwithstanding paragraph (b)(9)(ii)(A) of this section, this paragraph (b)(9)(ii)(F) applies to contingent stated interest payments that are adjusted to compensate for contingencies regarding the reasonableness of the debt instrument's stated rate of interest. For example, this paragraph (b)(9)(ii)(F) applies to a debt instrument that provides for an increase in the stated rate of interest if the credit quality of the issuer or liquidity of the debt instrument deteriorates. Contingent stated interest payments of this type are recognized over

the period to which they relate in a reasonable manner.

(G) *Special rule when all contingent payments become fixed.* Notwithstanding paragraph (b)(9)(ii)(A) of this section, if all the remaining contingent payments on a debt instrument become fixed substantially contemporaneously, any positive or negative adjustments on the instrument are taken into account in a reasonable manner over the period to which they relate. For purposes of the preceding sentence, a payment is treated as a fixed payment if all remaining contingencies with respect to the payment are remote or incidental (within the meaning of § 1.1275–2(h)).

(H) *Example.* The following example illustrates the provisions of this paragraph (b)(9)(ii). In this example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes.

Example: Fixed but deferred payments. (i) *Facts.* On December 31, 1996, B, a calendar year taxpayer, purchases a debt instrument at original issue for $1,000. The debt instrument matures on December 31, 2002, and provides for a payment of $1,000 at maturity. In addition, on December 31, 1999, and December 31, 2002, the debt instrument provides for payments equal to the excess of the average daily value of an index for the 6-month period ending on September 30 of the preceding year over a specified amount. The debt instrument's comparable yield is 10 percent, compounded annually, and the instrument's projected payment schedule consists of a payment of $250 on December 31, 1999, and a payment of $1,439 on December 31, 2002. B uses annual accrual periods.

(ii) *Interest accrual for 1997.* Based on the projected payment schedule, B includes a total of $100 of daily portions of interest in income in 1997. B's adjusted basis in the debt instrument and the debt instrument's adjusted issue price on December 31, 1997, is $1,100.

(iii) *Interest accrual for 1998*—(A) *Adjustment.* Based on the projected payment schedule, B would include $110 of total daily portions of interest in income in 1998. However, assume that on September 30, 1998, the payment due on December 31, 1999, fixes at $300, rather than the projected $250. Thus, on September 30, 1998, B has an adjustment equal to the difference between the present value of the $300 fixed amount and the present value of the $250 projected amount of the contingent payment. The present values of the two payments are determined by discounting each payment from the date the payment is due (December 31, 1999) to the date the payment becomes fixed (September 30, 1998), using a discount rate equal to 10 percent, compounded annually. The present value of the fixed payment is $266.30 and the present value of the projected amount of the contingent payment is $221.91. Thus, on September 30, 1998, B has a positive adjustment of $44.39 ($266.30–$221.91).

(B) *Effect of adjustment.* Under paragraph (b)(9)(ii)(C) of this section, B's accrual period ends on September 30, 1998. The daily portions of interest on the debt instrument for the period from January 1, 1998 to September 30, 1998 total $81.51. The adjusted issue price of the debt instrument and B's adjusted basis in the debt instrument are thus increased over this period by $125.90 (the sum of the daily portions of interest of $81.51 and the positive adjustment of $44.39 made at the end of the period) to $1,225.90. For purposes of all future accrual periods, including the new accrual period from October 1, 1998, to December 31, 1998, the debt instrument's projected payment schedule is modified to reflect a fixed payment of $300 on December 31, 1999. Based on the new adjusted issue price of the debt instrument and the new projected payment schedule, the yield on the debt instrument does not change.

(C) *Interest accrual for 1998.* Based on the modified projected payment schedule, $29.56 of interest accrues during the accrual period that ends on December 31, 1998. Because B has no other adjustments during 1998, the $44.39 positive adjustment on September 30, 1998, results in a net positive adjustment for 1998, which is additional interest for that year. Thus, B includes $155.46 ($81.51 + $29.56 + $44.39) of interest in income in 1998. B's adjusted basis in the debt instrument and the debt instrument's adjusted issue price on December 31, 1998, is $1,255.46 ($1,225.90 from the end of the prior accrual period plus $29.56 total daily portions for the current accrual period).

(iii) *Timing contingencies.* This paragraph (b)(9)(iii) provides rules for debt instruments that have payments that are contingent as to time.

(A) *Treatment of certain options.* If a taxpayer has an unconditional option to put or call the debt instrument, to exchange the debt instrument for other property, or to extend the maturity date of the debt instrument, the projected payment schedule is determined by using the principles of § 1.1272–1(c)(5).

(B) *Other timing contingencies.* [Reserved]

(iv) *Cross-border transactions*—(A) *Allocation of deductions*. For purposes of § 1.861–8, the holder of a debt instrument shall treat any deduction or loss treated as an ordinary loss under paragraph (b)(6)(iii)(B) or (b)(8)(ii) of this section as a deduction that is definitely related to the class of gross income to which income from such debt instrument belongs. Accordingly, if a U.S. person holds a debt instrument issued by a related controlled foreign corporation and, pursuant to section 904(d)(3) and the regulations thereunder, any interest accrued by such U.S. person with respect to such debt instrument would be treated as foreign source general limitation income, any deductions relating to a net negative adjustment will reduce the U.S. person's foreign source general limitation income. The holder shall apply the general rules relating to allocation and apportionment of deductions to any other deduction or loss realized by the holder with respect to the debt instrument.

(B) *Investments in United States real property*. Notwithstanding paragraph (b)(8)(i) of this section, gain on the sale, exchange, or retirement of a debt instrument that is a United States real property interest is treated as gain for purposes of sections 897, 1445, and 6039C.

(v) *Coordination with subchapter M and related provisions*. For purposes of sections 852(c)(2) and 4982 and § 1.852–11, any positive adjustment, negative adjustment, income, or loss on a debt instrument that occurs after October 31 of a taxable year is treated in the same manner as foreign currency gain or loss that is attributable to a section 988 transaction.

(vi) *Coordination with section 1092*. A holder treats a negative adjustment and an issuer treats a positive adjustment as a loss with respect to a position in a straddle if the debt instrument is a position in a straddle and the contingency (or any portion of the contingency) to which the adjustment relates would be part of the straddle if entered into as a separate position.

(c) *Method for debt instruments not subject to the noncontingent bond method*—(1) *Applicability*. This paragraph (c) applies to a contingent payment debt instrument (other than a tax-exempt obligation) that has an issue price determined under § 1.1274–2. For example, this paragraph (c) generally applies to a contingent payment debt instrument that is issued for nonpublicly traded property.

(2) *Separation into components*. If paragraph (c) of this section applies to a debt instrument (the overall debt instrument), the noncontingent payments are subject to the rules in paragraph (c)(3) of this section, and the contingent payments are accounted for separately under the rules in paragraph (c)(4) of this section.

(3) *Treatment of noncontingent payments*. The noncontingent payments are treated as a separate debt instrument. The issue price of the separate debt instrument is the issue price of the overall debt instrument, determined under § 1.1274–2(g). No interest payments on the separate debt instrument are qualified stated interest payments (within the meaning of § 1.1273–1(c)) and the de minimis rules of section 1273(a)(3) and § 1.1273–1(d) do not apply to the separate debt instrument.

(4) *Treatment of contingent payments*—(i) *In general*. Except as provided in paragraph (c)(4)(iii) of this section, the portion of a contingent payment treated as interest under paragraph (c)(4)(ii) of this section is includible in gross income by the holder and deductible from gross income by the issuer in their respective taxable years in which the payment is made.

(ii) *Characterization of contingent payments as principal and interest*—(A) *General rule*. A contingent payment is treated as a payment of principal in an amount equal to the present value of the payment, determined by discounting the payment at the test rate from the date the payment is made to the issue date. The amount of the payment in excess of the amount treated as principal under the preceding sentence is treated as a payment of interest.

(B) *Test rate*. The test rate used for purposes of paragraph (c)(4)(ii)(A) of this section is the rate that would be the test rate for the overall debt instrument under § 1.1274–4 if the term of the overall debt instrument began on the issue date of the overall debt instrument and ended on the date the contingent payment is made. However,

in the case of a contingent payment that consists of a payment of stated principal accompanied by a payment of stated interest at a rate that exceeds the test rate determined under the preceding sentence, the test rate is the stated interest rate.

(iii) *Certain delayed contingent payments*—(A) *General rule*. Notwithstanding paragraph (c)(4)(ii) of this section, if a contingent payment becomes fixed more than 6 months before the payment is due, the issuer and holder are treated as if the issuer had issued a separate debt instrument on the date the payment becomes fixed, maturing on the date the payment is due. This separate debt instrument is treated as a debt instrument to which section 1274 applies. The stated principal amount of this separate debt instrument is the amount of the payment that becomes fixed. An amount equal to the issue price of this debt instrument is characterized as interest or principal under the rules of paragraph (c)(4)(ii) of this section and accounted for as if this amount had been paid by the issuer to the holder on the date that the amount of the payment becomes fixed. To determine the issue price of the separate debt instrument, the payment is discounted at the test rate from the maturity date of the separate debt instrument to the date that the amount of the payment becomes fixed.

(B) *Test rate*. The test rate used for purposes of paragraph (c)(4)(iii)(A) of this section is determined in the same manner as the test rate under paragraph (c)(4)(ii)(B) of this section is determined except that the date the contingent payment is due is used rather than the date the contingent payment is made.

(5) *Basis different from adjusted issue price*. This paragraph (c)(5) provides rules for a holder whose basis in a debt instrument is different from the instrument's adjusted issue price (e.g., a subsequent holder). This paragraph (c)(5), however, does not apply if the holder is reporting income under the installment method of section 453.

(i) *Allocation of basis*. The holder must allocate basis to the noncontingent component (i.e., the right to the noncontingent payments) and to any separate debt instruments described in paragraph (c)(4)(iii) of this section in an amount up to the total of the adjusted issue price of the noncontingent component and the adjusted issue prices of the separate debt instruments. The holder must allocate the remaining basis, if any, to the contingent component (i.e., the right to the contingent payments).

(ii) *Noncontingent component*. Any difference between the holder's basis in the noncontingent component and the adjusted issue price of the noncontingent component, and any difference between the holder's basis in a separate debt instrument and the adjusted issue price of the separate debt instrument, is taken into account under the rules for market discount, premium, and acquisition premium that apply to a noncontingent debt instrument.

(iii) *Contingent component*. Amounts received by the holder that are treated as principal payments under paragraph (c)(4)(ii) of this section reduce the holder's basis in the contingent component. If the holder's basis in the contingent component is reduced to zero, any additional principal payments on the contingent component are treated as gain from the sale or exchange of the debt instrument. Any basis remaining on the contingent component on the date the final contingent payment is made increases the holder's adjusted basis in the noncontingent component (or, if there are no remaining noncontingent payments, is treated as loss from the sale or exchange of the debt instrument).

(6) *Treatment of a holder on sale, exchange, or retirement*. This paragraph (c)(6) provides rules for the treatment of a holder on the sale, exchange, or retirement of a debt instrument subject to this paragraph (c). Under this paragraph (c)(6), the holder must allocate the amount received from the sale, exchange, or retirement of a debt instrument first to the noncontingent component and to any separate debt instruments described in paragraph (c)(4)(iii) of this section in an amount up to the total of the adjusted issue price of the noncontingent component and the adjusted issue prices of the separate debt instruments. The holder must allocate the remaining amount received, if any, to the contingent component.

(i) *Amount allocated to the noncontingent component.* The amount allocated to the noncontingent component and any separate debt instruments is treated as an amount realized from the sale, exchange, or retirement of the noncontingent component or separate debt instrument.

(ii) *Amount allocated to the contingent component.* The amount allocated to the contingent component is treated as a contingent payment that is made on the date of the sale, exchange, or retirement and is characterized as interest and principal under the rules of paragraph (c)(4)(ii) of this section.

(7) *Examples.* The following examples illustrate the provisions of this paragraph (c). In each example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes.

Example 1. Contingent interest payments. (i) *Facts.* A owns Blackacre, unencumbered depreciable real estate. On January 1, 1997, A sells Blackacre to B. As consideration for the sale, B makes a downpayment of $1,000,000 and issues to A a debt instrument that matures on December 31, 2001. The debt instrument provides for a payment of principal at maturity of $5,000,000 and a contingent payment of interest on December 31 of each year equal to a fixed percentage of the gross rents B receives from Blackacre in that year. Assume that the debt instrument is not issued in a potentially abusive situation. Assume also that on January 1, 1997, the short-term applicable Federal rate is 5 percent, compounded annually, and the mid-term applicable Federal rate is 6 percent, compounded annually.

(ii) *Determination of issue price.* Under § 1.1274–2(g), the issue price of the debt instrument is $3,736,291, which is the present value, as of the issue date, of the $5,000,000 noncontingent payment due at maturity, calculated using a discount rate equal to the mid-term applicable Federal rate. Under § 1.1012–1(g)(1), B's basis in Blackacre on January 1, 1997, is $4,736,291 ($1,000,000 down payment plus the $3,736,291 issue price of the debt instrument).

(iii) *Noncontingent payment treated as separate debt instrument.* Under paragraph (c)(3) of this section, the right to the noncontingent payment of principal at maturity is treated as a separate debt instrument. The issue price of this separate debt instrument is $3,736,291 (the issue price of the overall debt instrument). The separate debt instrument has a stated redemption price at maturity of $5,000,000 and, therefore, OID of $1,263,709.

(iv) *Treatment of contingent payments.* Assume that the amount of contingent interest that is fixed and paid on December 31, 1997, is $200,000. Under paragraph (c)(4)(ii) of this section, this payment is treated as consisting of a payment of principal of $190,476, which is the present value of the payment, determined by discounting the payment at the test rate of 5 percent, compounded annually, from the date the payment is made to the issue date. The remainder of the $200,000 payment ($9,524) is treated as interest. The additional amount treated as principal gives B additional basis in Blackacre on December 31, 1997. The portion of the payment treated as interest is includible in gross income by A and deductible by B in their respective taxable years in which December 31, 1997 occurs. The remaining contingent payments on the debt instrument are accounted for similarly, using a test rate of 5 percent, compounded annually, for the contingent payments due on December 31, 1998, and December 31, 1999, and a test rate of 6 percent, compounded annually, for the contingent payments due on December 31, 2000, and December 31, 2001.

Example 2. Fixed but deferred payment. (i) *Facts.* The facts are the same as in paragraph (c)(7) *Example 1* of this section, except that the contingent payment of interest that is fixed on December 31, 1997, is not payable until December 31, 2001, the maturity date.

(ii) *Treatment of deferred contingent payment.* Assume that the amount of the payment that becomes fixed on December 31, 1997, is $200,000. Because this amount is not payable until December 31, 2001, under paragraph (c)(4)(iii) of this section, a separate debt instrument to which section 1274 applies is treated as issued by B on December 31, 1997 (the date the payment is fixed). The maturity date of this separate debt instrument is December 31, 2001 (the date on which the payment is due). The stated principal amount of this separate debt instrument is $200,000, the amount of the payment that becomes fixed. The imputed principal amount of the separate debt instrument is $158,419, which is the present value, as of December 31, 1997, of the $200,000 payment, computed using a discount rate equal to the test rate of the overall debt instrument (6 percent, compounded annually). An amount equal to the issue price of the separate debt instrument is treated as an amount paid on December 31, 1997, and characterized as interest and principal under the rules of paragraph (c)(4)(ii) of this section. The amount of the deemed payment characterized as principal is equal to $150,875, which is the present value, as of January 1, 1997 (the issue date of the overall debt instrument), of the deemed payment, computed using a discount rate of 5 percent, compounded annually. The

amount of the deemed payment characterized as interest is $7,544 ($158,419 −$150,875), which is includible in gross income by A and deductible by B in their respective taxable years in which December 31, 1997 occurs.

(d) *Rules for tax-exempt obligations*—(1) *In general*. Except as modified by this paragraph (d), the noncontingent bond method described in paragraph (b) of this section applies to a tax-exempt obligation (as defined in section 1275(a)(3)) to which this section applies. Paragraph (d)(2) of this section applies to certain tax-exempt obligations that provide for interest-based payments or revenue-based payments and paragraph (d)(3) of this section applies to all other obligations. Paragraph (d)(4) of this section provides rules for a holder whose basis in a tax-exempt obligation is different from the adjusted issue price of the obligation.

(2) *Certain tax-exempt obligations with interest-based or revenue-based payments*—(i) *Applicability*. This paragraph (d)(2) applies to a tax-exempt obligation that provides for interest-based payments or revenue-based payments.

(ii) *Interest-based payments*. A tax-exempt obligation provides for interest-based payments if the obligation would otherwise qualify as a variable rate debt instrument under § 1.1275–5 except that—

(A) The obligation provides for more than one fixed rate;

(B) The obligation provides for one or more caps, floors, or governors (or similar restrictions) that are fixed as of the issue date;

(C) The interest on the obligation is not compounded or paid at least annually; or

(D) The obligation provides for interest at one or more rates equal to the product of a qualified floating rate and a fixed multiple greater than zero and less than .65, or at one or more rates equal to the product of a qualified floating rate and a fixed multiple greater than zero and less than .65, increased or decreased by a fixed rate.

(iii) *Revenue-based payments*. A tax-exempt obligation provides for revenue-based payments if the obligation—

(A) Is issued to refinance (including a series of refinancings) an obligation (in a series of refinancings, the original obligation), the proceeds of which were used to finance a project or enterprise; and

(B) Would otherwise qualify as a variable rate debt instrument under § 1.1275–5 except that it provides for stated interest payments at least annually based on a single fixed percentage of the revenue, value, change in value, or other similar measure of the performance of the refinanced project or enterprise.

(iv) *Modifications to the noncontingent bond method*. If a tax-exempt obligation is subject to this paragraph (d)(2), the following modifications to the noncontingent bond method described in paragraph (b) of this section apply to the obligation.

(A) *Daily portions and net positive adjustments*. The daily portions of interest determined under paragraph (b)(3)(iii) of this section and any net positive adjustment on the obligation are interest for purposes of section 103.

(B) *Net negative adjustments*. A net negative adjustment for a taxable year reduces the amount of tax-exempt interest the holder would otherwise account for on the obligation for the taxable year under paragraph (b)(3)(iii) of this section. If the net negative adjustment exceeds this amount, the excess is a nondeductible, noncapitalizable loss. If a regulated investment company (RIC) within the meaning of section 851 has a net negative adjustment in a taxable year that would be a nondeductible, noncapitalizable loss under the prior sentence, the RIC must use this loss to reduce its tax-exempt interest income on other tax-exempt obligations held during the taxable year.

(C) *Gains*. Any gain recognized on the sale, exchange, or retirement of the obligation is gain from the sale or exchange of the obligation.

(D) *Losses*. Any loss recognized on the sale, exchange, or retirement of the obligation is treated the same as a net negative adjustment under paragraph (d)(2)(iv)(B) of this section.

(E) *Special rule for losses and net negative adjustments*. Notwithstanding paragraphs (d)(2)(iv) (B) and (D) of this section, on the sale, exchange, or retirement of the obligation, the holder may claim a loss from the sale or exchange of the obligation to the extent the

holder has not received in cash or property the sum of its original investment in the obligation and any amounts included in income under paragraph (d)(4)(ii) of this section.

(3) *All other tax-exempt obligations*—(i) *Applicability*. This paragraph (d)(3) applies to a tax-exempt obligation that is not subject to paragraph (d)(2) of this section.

(ii) *Modifications to the noncontingent bond method*. If a tax-exempt obligation is subject to this paragraph (d)(3), the following modifications to the noncontingent bond method described in paragraph (b) of this section apply to the obligation.

(A) *Modification to projected payment schedule*. The comparable yield for the obligation is the greater of the obligation's yield, determined without regard to the contingent payments, and the tax-exempt applicable Federal rate that applies to the obligation. The Internal Revenue Service publishes the tax-exempt applicable Federal rate for each month in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter).

(B) *Daily portions*. The daily portions of interest determined under paragraph (b)(3)(iii) of this section are interest for purposes of section 103.

(C) *Adjustments*. A net positive adjustment on the obligation is treated as gain to the holder from the sale or exchange of the obligation in the taxable year of the adjustment. A net negative adjustment on the obligation is treated as a loss to the holder from the sale or exchange of the obligation in the taxable year of the adjustment.

(D) *Gains and losses*. Any gain or loss recognized on the sale, exchange, or retirement of the obligation is gain or loss from the sale or exchange of the obligation.

(4) *Basis different from adjusted issue price*. This paragraph (d)(4) provides rules for a holder whose basis in a tax-exempt obligation is different from the adjusted issue price of the obligation. The rules of paragraph (b)(9)(i) of this section do not apply to tax-exempt obligations.

(i) *Basis greater than adjusted issue price*. If the holder's basis in the obligation exceeds the obligation's adjusted issue price, the holder, upon acquiring the obligation, must allocate this difference to daily portions of interest on a yield to maturity basis over the remaining term of the obligation. The amount allocated to a daily portion of interest is not deductible by the holder. However, the holder's basis in the obligation is reduced by the amount allocated to a daily portion of interest on the date the daily portion accrues.

(ii) *Basis less than adjusted issue price*. If the holder's basis in the obligation is less than the obligation's adjusted issue price, the holder, upon acquiring the obligation, must allocate this difference to daily portions of interest on a yield to maturity basis over the remaining term of the obligation. The amount allocated to a daily portion of interest is includible in income by the holder as ordinary income on the date the daily portion accrues. The holder's adjusted basis in the obligation is increased by the amount includible in income by the holder under this paragraph (d)(4)(ii) on the date the daily portion accrues.

(iii) *Premium and discount rules do not apply*. The rules for accruing premium and discount in sections 171, 1276, and 1288 do not apply. Other rules of those sections continue to apply to the extent relevant.

(e) *Amounts treated as interest under this section*. Amounts treated as interest under this section are treated as OID for all purposes of the Internal Revenue Code.

(f) *Effective date*. This section applies to debt instruments issued on or after August 13, 1996.

[T.D. 8674, 61 FR 30143, June 14, 1996, as amended by T.D. 8709, 62 FR 618, Jan. 6, 1997; T.D. 8838, 64 FR 48547, Sept. 7, 1999; T.D. 9157, 69 FR 52829, Aug. 30, 2004; T.D. 9599, 77 FR 56538, Sept. 13, 2012; T.D. 9612, 78 FR 8016, Feb. 5, 2013]

§ 1.1275–5 Variable rate debt instruments.

(a) *Applicability*—(1) *In general*. This section provides rules for variable rate debt instruments. Except as provided in paragraph (a)(6) of this section, a variable rate debt instrument is a debt instrument that meets the conditions described in paragraphs (a)(2), (3), (4), and (5) of this section. If a debt instrument that provides for a variable rate

of interest does not qualify as a variable rate debt instrument, the debt instrument is a contingent payment debt instrument. See §1.1275–4 for the treatment of a contingent payment debt instrument. See §1.1275–6 for a taxpayer's treatment of a variable rate debt instrument and a hedge.

(2) *Principal payments.* The issue price of the debt instrument must not exceed the total noncontingent principal payments by more than an amount equal to the lesser of—

(i) .015 multiplied by the product of the total noncontingent principal payments and the number of complete years to maturity from the issue date (or, in the case of an installment obligation, the weighted average maturity as defined in §1.1273–1(e)(3)); or

(ii) 15 percent of the total noncontingent principal payments.

(3) *Stated interest*—(i) *General rule.* The debt instrument must not provide for any stated interest other than stated interest (compounded or paid at least annually) at—

(A) One or more qualified floating rates;

(B) A single fixed rate and one or more qualified floating rates;

(C) A single objective rate; or

(D) A single fixed rate and a single objective rate that is a qualified inverse floating rate.

(ii) *Certain debt instruments bearing interest at a fixed rate for an initial period.* If interest on a debt instrument is stated at a fixed rate for an initial period of 1 year or less followed by a variable rate that is either a qualified floating rate or an objective rate for a subsequent period, and the value of the variable rate on the issue date is intended to approximate the fixed rate, the fixed rate and the variable rate together constitute a single qualified floating rate or objective rate. A fixed rate and a variable rate will be conclusively presumed to meet the requirements of the preceding sentence if the value of the variable rate on the issue date does not differ from the value of the fixed rate by more than .25 percentage points (25 basis points).

(4) *Current value.* The debt instrument must provide that a qualified floating rate or objective rate in effect at any time during the term of the instrument is set at a current value of that rate. A current value is the value of the rate on any day that is no earlier than 3 months prior to the first day on which that value is in effect and no later than 1 year following that first day.

(5) *No contingent principal payments.* Except as provided in paragraph (a)(2) of this section, the debt instrument must not provide for any principal payments that are contingent (within the meaning of §1.1275–4(a)).

(6) *Special rule for debt instruments issued for nonpublicly traded property.* A debt instrument (other than a tax-exempt obligation) that would otherwise qualify as a variable rate debt instrument under this section is not a variable rate debt instrument if section 1274 applies to the instrument and any stated interest payments on the instrument are treated as contingent payments under §1.1274–2. This paragraph (a)(6) applies to debt instruments issued on or after August 13, 1996.

(b) *Qualified floating rate*—(1) *In general.* A variable rate is a qualified floating rate if variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which the debt instrument is denominated. The rate may measure contemporaneous variations in borrowing costs for the issuer of the debt instrument or for issuers in general. Except as provided in paragraph (b)(2) of this section, a multiple of a qualified floating rate is not a qualified floating rate. If a debt instrument provides for two or more qualified floating rates that can reasonably be expected to have approximately the same values throughout the term of the instrument, the qualified floating rates together constitute a single qualified floating rate. Two or more qualified floating rates will be conclusively presumed to meet the requirements of the preceding sentence if the values of all rates on the issue date are within .25 percentage points (25 basis points) of each other.

(2) *Certain rates based on a qualified floating rate.* For a debt instrument issued on or after August 13, 1996, a variable rate is a qualified floating rate if it is equal to either—

(i) The product of a qualified floating rate described in paragraph (b)(1) of this section and a fixed multiple that is greater than .65 but not more than 1.35; or

(ii) The product of a qualified floating rate described in paragraph (b)(1) of this section and a fixed multiple that is greater than .65 but not more than 1.35, increased or decreased by a fixed rate.

(3) *Restrictions on the stated rate of interest*. A variable rate is not a qualified floating rate if it is subject to a restriction or restrictions on the maximum stated interest rate (cap), a restriction or restrictions on the minimum stated interest rate (floor), a restriction or restrictions on the amount of increase or decrease in the stated interest rate (governor), or other similar restrictions. Notwithstanding the preceding sentence, the following restrictions will not cause a variable rate to fail to be a qualified floating rate—

(i) A cap, floor, or governor that is fixed throughout the term of the debt instrument;

(ii) A cap or similar restriction that is not reasonably expected as of the issue date to cause the yield on the debt instrument to be significantly less than the expected yield determined without the cap;

(iii) A floor or similar restriction that is not reasonably expected as of the issue date to cause the yield on the debt instrument to be significantly more than the expected yield determined without the floor; or

(iv) A governor or similar restriction that is not reasonably expected as of the issue date to cause the yield on the debt instrument to be significantly more or significantly less than the expected yield determined without the governor.

(c) *Objective rate*—(1) *Definition*—(i) *In general*. For debt instruments issued on or after August 13, 1996, an objective rate is a rate (other than a qualified floating rate) that is determined using a single fixed formula and that is based on objective financial or economic information. For example, an objective rate generally includes a rate that is based on one or more qualified floating rates or on the yield of actively traded personal property (within the meaning of section 1092(d)(1)).

(ii) *Exception*. For purposes of paragraph (c)(1)(i) of this section, an objective rate does not include a rate based on information that is within the control of the issuer (or a related party within the meaning of section 267(b) or 707(b)(1)) or that is unique to the circumstances of the issuer (or a related party within the meaning of section 267(b) or 707(b)(1)), such as dividends, profits, or the value of the issuer's stock. However, a rate does not fail to be an objective rate merely because it is based on the credit quality of the issuer.

(2) *Other objective rates to be specified by Commissioner*. The Commissioner may designate in the Internal Revenue Bulletin variable rates other than those described in paragraph (c)(1) of this section that will be treated as objective rates (see §601.601(d)(2)(ii) of this chapter).

(3) *Qualified inverse floating rate*. An objective rate described in paragraph (c)(1) of this section is a qualified inverse floating rate if—

(i) The rate is equal to a fixed rate minus a qualified floating rate; and

(ii) The variations in the rate can reasonably be expected to inversely reflect contemporaneous variations in the qualified floating rate (disregarding any restrictions on the rate that are described in paragraphs (b)(3)(i), (b)(3)(ii), (b)(3)(iii), and (b)(3)(iv) of this section).

(4) *Significant front-loading or back-loading of interest*. Notwithstanding paragraph (c)(1) of this section, a variable rate of interest on a debt instrument is not an objective rate if it is reasonably expected that the average value of the rate during the first half of the instrument's term will be either significantly less than or significantly greater than the average value of the rate during the final half of the instrument's term.

(5) *Tax-exempt obligations*. Notwithstanding paragraph (c)(1) of this section, in the case of a tax-exempt obligation (within the meaning of section 1275(a)(3)), a variable rate is an objective rate only if it is a qualified inverse floating rate or a qualified inflation rate. A rate is a qualified inflation rate if the rate measures contemporaneous

changes in inflation based on a general inflation index.

(d) *Examples*. The following examples illustrate the rules of paragraphs (b) and (c) of this section. For purposes of these examples, assume that the debt instrument is not a tax-exempt obligation. In addition, unless otherwise provided, assume that the rate is not reasonably expected to result in a significant front-loading or back-loading of interest and that the rate is not based on objective financial or economic information that is within the control of the issuer (or a related party) or that is unique to the circumstances of the issuer (or a related party).

Example 1. Rate based on LIBOR. X issues a debt instrument that provides for annual payments of interest at a rate equal to the value of the 1-year London Interbank Offered Rate (LIBOR) at the end of each year. Variations in the value of 1-year LIBOR over the term of the debt instrument can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds over that term. Accordingly, the rate is a qualified floating rate.

Example 2. Rate increased by a fixed amount. X issues a debt instrument that provides for annual payments of interest at a rate equal to 200 basis points (2 percent) plus the current value, at the end of each year, of the average yield on 1-year Treasury securities as published in Federal Reserve bulletins. Variations in the value of this interest rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is a qualified floating rate.

Example 3. Rate based on commercial paper rate. X issues a debt instrument that provides for a rate of interest that is periodically adjusted to equal the current interest rate of Bank's commercial paper. Variations in the value of this interest rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is a qualified floating rate.

Example 4. Rate based on changes in the value of a commodity index. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to the percentage increase, if any, in the value of an index for the year immediately preceding the payment. The index is based on the prices of several actively traded commodities. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. However, because the rate is based on objective financial information using a single fixed formula, the rate is an objective rate.

Example 5. Rate based on a percentage of S&P 500 Index. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year based on a fixed percentage of the value of the S&P 500 Index. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds and, therefore, the rate is not a qualified floating rate. Although the rate is described in paragraph (c)(1)(i) of this section, the rate is not an objective rate because, based on historical data, it is reasonably expected that the average value of the rate during the first half of the instrument's term will be significantly less than the average value of the rate during the final half of the instrument's term.

Example 6. Rate based on issuer's profits. On January 1, 1997, Z issues a debt instrument that provides for annual interest payments equal to 1 percent of Z's gross profits earned during the year immediately preceding the payment. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. In addition, because the rate is based on information that is unique to the issuer's circumstances, the rate is not an objective rate.

Example 7. Rate based on a multiple of an interest index. On January 1, 1997, Z issues a debt instrument with annual interest payments at a rate equal to two times the value of 1-year LIBOR as of the payment date. Because the rate is a multiple greater than 1.35 times a qualified floating rate, the rate is not a qualified floating rate. However, because the rate is based on objective financial information using a single fixed formula, the rate is an objective rate.

Example 8. Variable rate based on the cost of borrowed funds in a foreign currency. On January 1, 1997, Y issues a 5-year dollar denominated debt instrument that provides for annual interest payments at a rate equal to the value of 1-year French franc LIBOR as of the payment date. Variations in the value of French franc LIBOR do not measure contemporaneous changes in the cost of newly borrowed funds in dollars. As a result, the rate is not a qualified floating rate for an instrument denominated in dollars. However, because the rate is based on objective financial information using a single fixed formula, the rate is an objective rate.

Example 9. Qualified inverse floating rate. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to 12 percent minus the value of 1-year LIBOR as of the payment date. On the issue date, the value of 1-year LIBOR is 6 percent. Because

the rate can reasonably be expected to inversely reflect contemporaneous variations in 1-year LIBOR, it is a qualified inverse floating rate. However, if the value of 1-year LIBOR on the issue date were 11 percent rather than 6 percent, the rate would not be a qualified inverse floating rate because the rate could not reasonably be expected to inversely reflect contemporaneous variations in 1-year LIBOR.

Example 10. Rate based on an inflation index. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to 400 basis points (4 percent) plus the annual percentage change in a general inflation index (e.g., the Consumer Price Index, U.S. City Average, All Items, for all Urban Consumers, seasonally unadjusted). The rate, however, may not be less than zero. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. However, because the rate is based on objective economic information using a single fixed formula, the rate is an objective rate.

(e) *Qualified stated interest and OID with respect to a variable rate debt instrument*—(1) *In general.* This paragraph (e) provides rules to determine the amount and accrual of OID and qualified stated interest on a variable rate debt instrument. In general, the rules convert the debt instrument into a fixed rate debt instrument and then apply the general OID rules to the debt instrument. The issue price of a variable rate debt instrument, however, is not determined under this paragraph (e). See §§ 1.1273–2 and 1.1274–2 to determine the issue price of a variable rate debt instrument.

(2) *Variable rate debt instrument that provides for annual payments of interest at a single variable rate.* If a variable rate debt instrument provides for stated interest at a single qualified floating rate or objective rate and the interest is unconditionally payable in cash or in property (other than debt instruments of the issuer), or will be constructively received under section 451, at least annually, the following rules apply to the instrument:

(i) All stated interest with respect to the debt instrument is qualified stated interest.

(ii) The amount of qualified stated interest and the amount of OID, if any, that accrues during an accrual period is determined under the rules applicable to fixed rate debt instruments by assuming that the variable rate is a fixed rate equal to—

(A) In the case of a qualified floating rate or qualified inverse floating rate, the value, as of the issue date, of the qualified floating rate or qualified inverse floating rate; or

(B) In the case of an objective rate (other than a qualified inverse floating rate), a fixed rate that reflects the yield that is reasonably expected for the debt instrument.

(iii) The qualified stated interest allocable to an accrual period is increased (or decreased) if the interest actually paid during an accrual period exceeds (or is less than) the interest assumed to be paid during the accrual period under paragraph (e)(2)(ii) of this section.

(3) *All other variable rate debt instruments except for those that provide for a fixed rate.* If a variable rate debt instrument is not described in paragraph (e)(2) of this section and does not provide for interest payable at a fixed rate (other than an initial fixed rate described in paragraph (a)(3)(ii) of this section), the amount of interest and OID accruals for the instrument are determined under this paragraph (e)(3).

(i) *Step one: Determine the fixed rate substitute for each variable rate provided under the debt instrument*—(A) *Qualified floating rate.* The fixed rate substitute for each qualified floating rate provided for in the debt instrument is the value of each rate as of the issue date. If, however, a variable rate debt instrument provides for two or more qualified floating rates with different intervals between interest adjustment dates, the fixed rate substitutes for the rates must be based on intervals that are equal in length. For example, if a 4-year debt instrument provides for 24 monthly interest payments based on the value of the 30-day commercial paper rate on each payment date followed by 8 quarterly interest payments based on the value of quarterly LIBOR on each payment date, the fixed rate substitutes may be based on the values, as of the issue date, of the 90-day commercial paper rate and quarterly LIBOR. Alternatively, the fixed rate substitutes may be based on the values,

as of the issue date, of the 30-day commercial paper rate and monthly LIBOR.

(B) *Qualified inverse floating rate.* The fixed rate substitute for a qualified inverse floating rate is the value of the qualified inverse floating rate as of the issue date.

(C) *Objective rate.* The fixed rate substitute for an objective rate (other than a qualified inverse floating rate) is a fixed rate that reflects the yield that is reasonably expected for the debt instrument.

(ii) *Step two: Construct the equivalent fixed rate debt instrument.* The equivalent fixed rate debt instrument has terms that are identical to those provided under the variable rate debt instrument, except that the equivalent fixed rate debt instrument provides for the fixed rate substitutes (determined in paragraph (e)(3)(i) of this section) in lieu of the qualified floating rates or objective rate provided under the variable rate debt instrument.

(iii) *Step three: Determine the amount of qualified stated interest and OID with respect to the equivalent fixed rate debt instrument.* The amount of qualified stated interest and OID, if any, are determined for the equivalent fixed rate debt instrument under the rules applicable to fixed rate debt instruments and are taken into account as if the holder held the equivalent fixed rate debt instrument.

(iv) *Step four: Make appropriate adjustments for actual variable rates.* Qualified stated interest or OID allocable to an accrual period must be increased (or decreased) if the interest actually accrued or paid during an accrual period exceeds (or is less than) the interest assumed to be accrued or paid during the accrual period under the equivalent fixed rate debt instrument. This increase or decrease is an adjustment to qualified stated interest for the accrual period if the equivalent fixed rate debt instrument (as determined under paragraph (e)(3)(ii) of this section) provides for qualified stated interest and the increase or decrease is reflected in the amount actually paid during the accrual period. Otherwise, this increase or decrease is an adjustment to OID for the accrual period.

(v) *Examples.* The following examples illustrate the rules in paragraphs (e) (2) and (3) of this section:

Example 1. Equivalent fixed rate debt instrument. (i) *Facts.* X purchases at original issue a 6-year variable rate debt instrument that provides for semiannual payments of interest. For the first 3 years, the rate of interest is the value of 6-month LIBOR on the payment date. For the final 3 years, the rate is the value of the 6-month T-bill rate on the payment date. On the issue date, the value of 6-month LIBOR is 3 percent, compounded semiannually, and the 6-month T-bill rate is 2 percent, compounded semiannually.

(ii) *Determination of equivalent fixed rate debt instrument.* Under paragraph (e)(3)(i) of this section, the fixed rate substitute for 6-month LIBOR is 3 percent, compounded semiannually, and the fixed rate substitute for the 6-month T-bill rate is 2 percent, compounded semiannually. Under paragraph (e)(3)(ii) of this section, the equivalent fixed rate debt instrument is a 6-year debt instrument that provides for semiannual payments of interest at 3 percent, compounded semiannually, for the first 3 years followed by 2 percent, compounded semiannually, for the final 3 years.

Example 2. Equivalent fixed rate debt instrument with de minimis OID. (i) *Facts.* Y purchases at original issue, for $100,000, a 4-year variable rate debt instrument that has a stated principal amount of $100,000, payable at maturity. The debt instrument provides for monthly payments of interest at the end of each month. For the first year, the interest rate is the monthly commercial paper rate and for the last 3 years, the interest rate is the monthly commercial paper rate plus 100 basis points. On the issue date, the monthly commercial paper rate is 3 percent, compounded monthly.

(ii) *Equivalent fixed rate debt instrument.* Under paragraph (e)(3)(ii) of this section, the equivalent fixed rate debt instrument for the variable rate debt instrument is a 4-year debt instrument that has an issue price and stated principal amount of $100,000. The equivalent fixed rate debt instrument provides for monthly payments of interest at 3 percent, compounded monthly, for the first year ($250 per month) and monthly payments of interest at 4 percent, compounded monthly, for the last 3 years ($333.33 per month).

(iii) *De minimis OID.* Under §1.1273–1(a), because a portion (100 basis points) of each interest payment in the final 3 years is not a qualified stated interest payment, the equivalent fixed rate debt instrument has OID of $2,999.88 ($102,999.88 − $100,000). However, under §1.1273–1(d)(4) (the de minimis rule relating to teaser rates and interest holidays), the stated redemption price at maturity of the equivalent fixed rate debt instrument is $100,999.96 ($100,000 (issue price) plus $999.96

(the greater of the amount of foregone interest ($999.96) and the amount equal to the excess of the instrument's stated principal amount over its issue price ($0)). Thus, the equivalent fixed rate debt instrument is treated as having OID of $999.96 ($100,999.96 − $100,000). Because this amount is less than the de minimis amount of $1,010 (0.0025 multiplied by $100,999.96 multiplied by 4 complete years to maturity), the equivalent fixed rate debt instrument has de minimis OID. Therefore, the variable rate debt instrument has zero OID and all stated interest payments are qualified stated interest payments.

Example 3. Adjustment to qualified stated interest for actual payment of interest. (i) *Facts.* On January 1, 1995, Z purchases at original issue, for $90,000, a variable rate debt instrument that matures on January 1, 1997, and has a stated principal amount of $100,000, payable at maturity. The debt instrument provides for annual payments of interest on January 1 of each year, beginning on January 1, 1996. The amount of interest payable is the value of annual LIBOR on the payment date. The value of annual LIBOR on January 1, 1995, and January 1, 1996, is 5 percent, compounded annually. The value of annual LIBOR on January 1, 1997, is 7 percent, compounded annually.

(ii) *Accrual of OID and qualified stated interest.* Under paragraph (e)(2) of this section, the variable rate debt instrument is treated as a 2-year debt instrument that has an issue price of $90,000, a stated principal amount of $100,000, and interest payments of $5,000 at the end of each year. The debt instrument has $10,000 of OID and the annual interest payments of $5,000 are qualified stated interest payments. Under § 1.1272–1, the debt instrument has a yield of 10.82 percent, compounded annually. The amount of OID allocable to the first annual accrual period (assuming Z uses annual accrual periods) is $4,743.25 (($90,000 × .1082) − $5,000), and the amount of OID allocable to the second annual accrual period is $5,256.75 ($100,000 − $94,743.25). Under paragraph (e)(2)(iii) of this section, the $2,000 difference between the $7,000 interest payment actually made at maturity and the $5,000 interest payment assumed to be made at maturity under the equivalent fixed rate debt instrument is treated as additional qualified stated interest for the period.

(4) *Variable rate debt instrument that provides for a single fixed rate*—(i) *General rule.* If a variable rate debt instrument provides for stated interest either at one or more qualified floating rates or at a qualified inverse floating rate and in addition provides for stated interest at a single fixed rate (other than an initial fixed rate described in paragraph (a)(3)(ii) of this section), the amount of interest and OID are determined using the method of paragraph (e)(3) of this section, as modified by this paragraph (e)(4). For purposes of paragraphs (e)(3)(i) through (e)(3)(iii) of this section, the variable rate debt instrument is treated as if it provided for a qualified floating rate (or a qualified inverse floating rate, if the debt instrument provides for a qualified inverse floating rate), rather than the fixed rate. The qualified floating rate (or qualified inverse floating rate) replacing the fixed rate must be such that the fair market value of the variable rate debt instrument as of the issue date would be approximately the same as the fair market value of an otherwise identical debt instrument that provides for the qualified floating rate (or qualified inverse floating rate) rather than the fixed rate.

(ii) *Example.* The following example illustrates the rule in paragraph (e)(4)(i) of this section.

Example: Variable rate debt instrument that provides for a single fixed rate. (i) *Facts.* On January 1, 1995, X purchases at original issue, for $100,000, a variable rate debt instrument that matures on January 1, 2001, and that has a stated principal amount of $100,000. The debt instrument provides for payments of interest on January 1 of each year, beginning on January 1, 1996. For the first 4 years, the interest rate is 4 percent, compounded annually, and for the last 2 years the interest rate is the value of 1-year LIBOR, as of the payment date, plus 200 basis points. On January 1, 1995, the value of 1-year LIBOR is 2 percent, compounded annually. In addition, assume that on January 1, 1995, the variable rate debt instrument has approximately the same fair market value as an otherwise identical debt instrument that provides for an interest rate equal to the value of 1-year LIBOR, as of the payment date, for the first 4 years.

(ii) *Equivalent fixed rate debt instrument.* Under paragraph (e)(4)(i) of this section, for purposes of paragraphs (e)(3)(i) through (e)(3)(iii) of this section, the variable rate debt instrument is treated as if it provided for an interest rate equal to the value of 1-year LIBOR, as of the payment date, for the first 4 years. Under paragraph (e)(3)(ii) of this section, the equivalent fixed rate debt instrument for the variable rate debt instrument is a 6-year debt instrument that has an issue price and stated principal amount of $100,000. The equivalent fixed rate debt instrument provides for interest payments of

$2,000 for the first 4 years and $4,000 for the last 2 years.

(iii) *Accrual of OID and qualified stated interest.* Under § 1.1273–1, the equivalent fixed rate debt instrument has OID of $4,000 because a portion (200 basis points) of each interest payment in the last 2 years is not a qualified stated interest payment. The $4,000 of OID is allocable over the 6-year term of the debt instrument under § 1.1272–1. Under paragraph (e)(3)(iv) of this section, the difference between the $4,000 payment made in the first 4 years and the $2,000 payment assumed to be made on the equivalent fixed rate debt instrument in those years is an adjustment to qualified stated interest. In addition, any difference between the amount actually paid in each of the last 2 years and the $4,000 payment assumed to be made on the equivalent fixed rate debt instrument is an adjustment to qualified stated interest.

(f) *Special rule for certain reset bonds.* Notwithstanding paragraph (e) of this section, this paragraph (f) provides a special rule for a variable rate debt instrument that provides for stated interest at a fixed rate for an initial interval, and provides that on the date immediately following the end of the initial interval (the effective date) the stated interest rate will be a rate determined under a procedure (such as an auction procedure) so that the fair market value of the instrument on the effective date will be a fixed amount (the reset value). Solely for purposes of calculating the accrual of OID, the variable rate debt instrument is treated as—

(1) Maturing on the date immediately preceding the effective date for an amount equal to the reset value; and

(2) Reissued on the effective date for an amount equal to the reset value.

[T.D. 8517, 59 FR 4827, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30153, June 14, 1996]

§ 1.1275–6 Integration of qualifying debt instruments.

(a) *In general.* This section generally provides for the integration of a qualifying debt instrument with a hedge or combination of hedges if the combined cash flows of the components are substantially equivalent to the cash flows on a fixed or variable rate debt instrument. The integrated transaction is generally subject to the rules of this section rather than the rules to which each component of the transaction would be subject on a separate basis. The purpose of this section is to permit a more appropriate determination of the character and timing of income, deductions, gains, or losses than would be permitted by separate treatment of the components. The rules of this section affect only the taxpayer who holds (or issues) the qualifying debt instrument and enters into the hedge.

(b) *Definitions*—(1) *Qualifying debt instrument.* A qualifying debt instrument is any debt instrument (including an integrated transaction as defined in paragraph (c) of this section) other than—

(i) A tax-exempt obligation as defined in section 1275(a)(3);

(ii) A debt instrument to which section 1272(a)(6) applies (certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration); or

(iii) A debt instrument that is subject to § 1.483–4 or § 1.1275–4(c) (certain contingent payment debt instruments issued for nonpublicly traded property).

(2) *Section 1.1275–6 hedge*—(i) *In general.* A § 1.1275–6 hedge is any financial instrument (as defined in paragraph (b)(3) of this section) if the combined cash flows of the financial instrument and the qualifying debt instrument permit the calculation of a yield to maturity (under the principles of section 1272), or the right to the combined cash flows would qualify under § 1.1275–5 as a variable rate debt instrument that pays interest at a qualified floating rate or rates (except for the requirement that the interest payments be stated as interest). A financial instrument is not a § 1.1275–6 hedge, however, if the resulting synthetic debt instrument does not have the same term as the remaining term of the qualifying debt instrument. A financial instrument that hedges currency risk is not a § 1.1275–6 hedge.

(ii) *Limitations*—(A) A debt instrument issued by a taxpayer and a debt instrument held by the taxpayer cannot be part of the same integrated transaction.

(B) A debt instrument can be a § 1.1275–6 hedge only if it is issued substantially contemporaneously with, and has the same maturity (including

rights to accelerate or delay payments) as, the qualifying debt instrument.

(3) *Financial instrument*. For purposes of this section, a financial instrument is a spot, forward, or futures contract, an option, a notional principal contract, a debt instrument, or a similar instrument, or combination or series of financial instruments. Stock is not a financial instrument for purposes of this section.

(4) *Synthetic debt instrument*. The synthetic debt instrument is the hypothetical debt instrument with the same cash flows as the combined cash flows of the qualifying debt instrument and the § 1.1275–6 hedge.

(c) *Integrated transaction*—(1) *Integration by taxpayer*. Except as otherwise provided in this section, a qualifying debt instrument and a § 1.1275–6 hedge are an integrated transaction if all of the following requirements are satisfied:

(i) The taxpayer satisfies the identification requirements of paragraph (e) of this section on or before the date the taxpayer enters into the § 1.1275–6 hedge.

(ii) None of the parties to the § 1.1275–6 hedge are related within the meaning of section 267(b) or 707(b)(1), or, if the parties are related, the party providing the hedge uses, for Federal income tax purposes, a mark-to-market method of accounting for the hedge and all similar or related transactions.

(iii) Both the qualifying debt instrument and the § 1.1275–6 hedge are entered into by the same individual, partnership, trust, estate, or corporation (regardless of whether the corporation is a member of an affiliated group of corporations that files a consolidated return).

(iv) If the taxpayer is a foreign person engaged in a U.S. trade or business and the taxpayer issues or acquires a qualifying debt instrument, or enters into a § 1.1275–6 hedge, through the trade or business, all items of income and expense associated with the qualifying debt instrument and the § 1.1275–6 hedge (other than interest expense that is subject to § 1.882–5) would have been effectively connected with the U.S. trade or business throughout the term of the qualifying debt instrument had this section not applied.

(v) Neither the qualifying debt instrument, nor any other debt instrument that is part of the same issue as the qualifying debt instrument, nor the § 1.1275–6 hedge was, with respect to the taxpayer, part of an integrated transaction that was terminated or otherwise legged out of within the 30 days immediately preceding the date that would be the issue date of the synthetic debt instrument.

(vi) The qualifying debt instrument is issued or acquired by the taxpayer on or before the date of the first payment on the § 1.1275–6 hedge, whether made or received by the taxpayer (including a payment made to purchase the hedge). If the qualifying debt instrument is issued or acquired by the taxpayer after, but substantially contemporaneously with, the date of the first payment on the § 1.1275–6 hedge, the qualifying debt instrument is treated, solely for purposes of this paragraph (c)(1)(vi), as meeting the requirements of the preceding sentence.

(vii) Neither the § 1.1275–6 hedge nor the qualifying debt instrument was, with respect to the taxpayer, part of a straddle (as defined in section 1092(c)) prior to the issue date of the synthetic debt instrument.

(2) *Integration by Commissioner*. The Commissioner may treat a qualifying debt instrument and a financial instrument (whether entered into by the taxpayer or by a related party) as an integrated transaction if the combined cash flows on the qualifying debt instrument and financial instrument are substantially the same as the combined cash flows required for the financial instrument to be a § 1.1275–6 hedge. The Commissioner, however, may not integrate a transaction unless the qualifying debt instrument either is subject to § 1.1275–4 or is subject to § 1.1275–5 and pays interest at an objective rate. The circumstances under which the Commissioner may require integration include, but are not limited to, the following:

(i) A taxpayer fails to identify a qualifying debt instrument and the § 1.1275–6 hedge under paragraph (e) of this section.

(ii) A taxpayer issues or acquires a qualifying debt instrument and a related party (within the meaning of section 267(b) or 707(b)(1)) enters into the § 1.1275–6 hedge.

(iii) A taxpayer issues or acquires a qualifying debt instrument and enters into the § 1.1275–6 hedge with a related party (within the meaning of section 267(b) or 707(b)(1)).

(iv) The taxpayer legs out of an integrated transaction and within 30 days enters into a new § 1.1275–6 hedge with respect to the same qualifying debt instrument or another debt instrument that is part of the same issue.

(d) *Special rules for legging into and legging out of an integrated transaction*—(1) *Legging into*—(i) *Definition*. Legging into an integrated transaction under this section means that a § 1.1275–6 hedge is entered into after the date the qualifying debt instrument is issued or acquired by the taxpayer, and the requirements of paragraph (c)(1) of this section are satisfied on the date the § 1.1275–6 hedge is entered into (the leg-in date).

(ii) *Treatment*. If a taxpayer legs into an integrated transaction, the taxpayer treats the qualifying debt instrument under the applicable rules for taking interest and OID into account up to the leg-in date, except that the day before the leg-in date is treated as the end of an accrual period. As of the leg-in date, the qualifying debt instrument is subject to the rules of paragraph (f) of this section.

(iii) *Anti-abuse rule*. If a taxpayer legs into an integrated transaction with a principal purpose of deferring or accelerating income or deductions on the qualifying debt instrument, the Commissioner may—

(A) Treat the qualifying debt instrument as sold for its fair market value on the leg-in date; or

(B) Refuse to allow the taxpayer to integrate the qualifying debt instrument and the § 1.1275–6 hedge.

(2) *Legging out*—(i) *Definition*—(A) *Legging out if the taxpayer has integrated*. If a taxpayer has integrated a qualifying debt instrument and a § 1.1275–6 hedge under paragraph (c)(1) of this section, legging out means that, prior to the maturity of the synthetic debt instrument, the § 1.1275–6 hedge ceases to meet the requirements for a § 1.1275–6 hedge, the taxpayer fails to meet any requirement of paragraph (c)(1) of this section, or the taxpayer disposes of or otherwise terminates all or a part of the qualifying debt instrument or § 1.1275–6 hedge. If the taxpayer fails to meet the requirements of paragraph (c)(1) of this section but meets the requirements of paragraph (c)(2) of this section, the Commissioner may treat the taxpayer as not legging out.

(B) *Legging out if the Commissioner has integrated*. If the Commissioner has integrated a qualifying debt instrument and a financial instrument under paragraph (c)(2) of this section, legging out means that, prior to the maturity of the synthetic debt instrument, the requirements for Commissioner integration under paragraph (c)(2) of this section are not met or the taxpayer fails to meet the requirements for taxpayer integration under paragraph (c)(1) of this section and the Commissioner agrees to allow the taxpayer to be treated as legging out.

(C) *Exception for certain nonrecognition transactions*. If, in a single nonrecognition transaction, a taxpayer disposes of, or ceases to be primarily liable on, the qualifying debt instrument and the § 1.1275–6 hedge, the taxpayer is not treated as legging out. Instead, the integrated transaction is treated under the rules governing the nonrecognition transaction. For example, if a holder of an integrated transaction is acquired in a reorganization under section 368(a)(1)(A), the holder is treated as disposing of the synthetic debt instrument in the reorganization rather than legging out. If the successor holder is not eligible for integrated treatment, the successor is treated as legging out.

(ii) *Operating rules*. If a taxpayer legs out (or is treated as legging out) of an integrated transaction, the following rules apply:

(A) The transaction is treated as an integrated transaction during the time the requirements of paragraph (c) (1) or (2) of this section, as appropriate, are satisfied.

(B) Immediately before the taxpayer legs out, the taxpayer is treated as selling or otherwise terminating the synthetic debt instrument for its fair market value and, except as provided

in paragraph (d)(2)(ii)(D) of this section, any income, deduction, gain, or loss is realized and recognized at that time.

(C) If, immediately after the taxpayer legs out, the taxpayer holds or remains primarily liable on the qualifying debt instrument, adjustments are made to reflect any difference between the fair market value of the qualifying debt instrument and the adjusted issue price of the qualifying debt instrument. If, immediately after the taxpayer legs out, the taxpayer is a party to a § 1.1275–6 hedge, the § 1.1275–6 hedge is treated as entered into at its fair market value.

(D) If a taxpayer legs out of an integrated transaction by disposing of or otherwise terminating a § 1.1275–6 hedge within 30 days of legging into the integrated transaction, then any loss or deduction determined under paragraph (d)(2)(ii)(B) of this section is not allowed. Appropriate adjustments are made to the qualifying debt instrument for any disallowed loss. The adjustments are taken into account on a yield to maturity basis over the remaining term of the qualifying debt instrument.

(E) If a holder of a debt instrument subject to § 1.1275–4 legs into an integrated transaction with respect to the instrument and subsequently legs out of the integrated transaction, any gain recognized under paragraph (d)(2)(ii)(B) or (C) of this section is treated as interest income to the extent determined under the principles of § 1.1275–4(b)(8)(iii)(B) (rules for determining the character of gain on the sale of a debt instrument all of the payments on which have been fixed). If the synthetic debt instrument would qualify as a variable rate debt instrument, the equivalent fixed rate debt instrument determined under § 1.1275–5(e) is used for this purpose.

(e) *Identification requirements.* For each integrated transaction, a taxpayer must enter and retain as part of its books and records the following information—

(1) The date the qualifying debt instrument was issued or acquired (or is expected to be issued or acquired) by the taxpayer and the date the § 1.1275–6 hedge was entered into by the taxpayer;

(2) A description of the qualifying debt instrument and the § 1.1275–6 hedge; and

(3) A summary of the cash flows and accruals resulting from treating the qualifying debt instrument and the § 1.1275–6 hedge as an integrated transaction (i.e., the cash flows and accruals on the synthetic debt instrument).

(f) *Taxation of integrated transactions*—(1) *General rule.* An integrated transaction is generally treated as a single transaction by the taxpayer during the period that the transaction qualifies as an integrated transaction. Except as provided in paragraph (f)(12) of this section, while a qualifying debt instrument and a § 1.1275–6 hedge are part of an integrated transaction, neither the qualifying debt instrument nor the § 1.1275–6 hedge is subject to the rules that would apply on a separate basis to the debt instrument and the § 1.1275–6 hedge, including section 1092 or § 1.446–4. The rules that would govern the treatment of the synthetic debt instrument generally govern the treatment of the integrated transaction. For example, the integrated transaction may be subject to section 263(g) or, if the synthetic debt instrument would be part of a straddle, section 1092. Generally, the synthetic debt instrument is subject to sections 163(e) and 1271 through 1275, with terms as set forth in paragraphs (f) (2) through (13) of this section.

(2) *Issue date.* The issue date of the synthetic debt instrument is the first date on which the taxpayer entered into all of the components of the synthetic debt instrument.

(3) *Term.* The term of the synthetic debt instrument is the period beginning on the issue date of the synthetic debt instrument and ending on the maturity date of the qualifying debt instrument.

(4) *Issue price.* The issue price of the synthetic debt instrument is the adjusted issue price of the qualifying debt instrument on the issue date of the synthetic debt instrument. If, as a result of entering into the § 1.1275–6 hedge, the taxpayer pays or receives one or more payments that are substantially contemporaneous with the

issue date of the synthetic debt instrument, the payments reduce or increase the issue price as appropriate.

(5) *Adjusted issue price.* In general, the adjusted issue price of the synthetic debt instrument is determined under the principles of § 1.1275–1(b).

(6) *Qualified stated interest.* No amounts payable on the synthetic debt instrument are qualified stated interest within the meaning of § 1.1273–1(c).

(7) *Stated redemption price at maturity*—(i) *Synthetic debt instruments that are borrowings.* In general, if the synthetic debt instrument is a borrowing, the instrument's stated redemption price at maturity is the sum of all amounts paid or to be paid on the qualifying debt instrument and the § 1.1275–6 hedge, reduced by any amounts received or to be received on the § 1.1275–6 hedge.

(ii) *Synthetic debt instruments that are held by the taxpayer.* In general, if the synthetic debt instrument is held by the taxpayer, the instrument's stated redemption price at maturity is the sum of all amounts received or to be received by the taxpayer on the qualifying debt instrument and the § 1.1275–6 hedge, reduced by any amounts paid or to be paid by the taxpayer on the § 1.1275–6 hedge.

(iii) *Certain amounts ignored.* For purposes of this paragraph (f)(7), if an amount paid or received on the § 1.1275–6 hedge is taken into account under paragraph (f)(4) of this section to determine the issue price of the synthetic debt instrument, the amount is not taken into account to determine the synthetic debt instrument's stated redemption price at maturity.

(8) *Source of interest income and allocation of expense.* The source of interest income from the synthetic debt instrument is determined by reference to the source of income of the qualifying debt instrument under sections 861(a)(1) and 862(a)(1). For purposes of section 904, the character of interest from the synthetic debt instrument is determined by reference to the character of the interest income from the qualifying debt instrument. Interest expense is allocated and apportioned under regulations under section 861 or under § 1.882–5.

(9) *Effectively connected income.* If the requirements of paragraph (c)(1)(iv) of this section are satisfied, any interest income resulting from the synthetic debt instrument entered into by the foreign person is treated as effectively connected with a U.S. trade or business, and any interest expense resulting from the synthetic debt instrument entered into by the foreign person is allocated and apportioned under § 1.882–5.

(10) *Not a short-term obligation.* For purposes of section 1272(a)(2)(C), a synthetic debt instrument is not treated as a short-term obligation.

(11) *Special rules in the event of integration by the Commissioner.* If the Commissioner requires integration, appropriate adjustments are made to the treatment of the synthetic debt instrument, and, if necessary, the qualifying debt instrument and financial instrument. For example, the Commissioner may treat a financial instrument that is not a § 1.1275–6 hedge as a § 1.1275–6 hedge when applying the rules of this section. The issue date of the synthetic debt instrument is the date determined appropriate by the Commissioner to require integration.

(12) *Retention of separate transaction rules for certain purposes.* This paragraph (f)(12) provides for the retention of separate transaction rules for certain purposes. In addition, by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter), the Commissioner may require use of separate transaction rules for any aspect of an integrated transaction.

(i) *Foreign persons that enter into integrated transactions giving rise to U.S. source income not effectively connected with a U.S. trade or business.* If a foreign person enters into an integrated transaction that gives rise to U.S. source interest income (determined under the source rules for the synthetic debt instrument) not effectively connected with a U.S. trade or business of the foreign person, paragraph (f) of this section does not apply for purposes of sections 871(a), 881, 1441, 1442, and 6049. These sections of the Internal Revenue Code are applied to the qualifying debt instrument and the § 1.1275–6 hedge on a separate basis.

(ii) *Relationship between taxpayer and other persons.* Because the rules of this

section affect only the taxpayer that enters into an integrated transaction (i.e., either the issuer or a particular holder of a qualifying debt instrument), any provisions of the Internal Revenue Code or regulations that govern the relationship between the taxpayer and any other person are applied on a separate basis. For example, taxpayers must comply with any reporting or disclosure requirements on any qualifying debt instrument as if it were not part of an integrated transaction. Thus, if required under §1.1275–4(b)(4), an issuer of a contingent payment debt instrument subject to integrated treatment must provide the projected payment schedule to holders. Similarly, if a U.S. corporation enters into an integrated transaction that includes a notional principal contract, the source of any payment received by the counterparty on the notional principal contract is determined under §1.863–7 as if the contract were not part of an integrated transaction, and, if received by a foreign person who is not engaged in a U.S. trade or business, the payment is non-U.S. source income that is not subject to U.S. withholding tax.

(13) *Coordination with consolidated return rules.* If a taxpayer enters into a §1.1275–6 hedge with a member of the same consolidated group (the counterparty) and the §1.1275–6 hedge is part of an integrated transaction for the taxpayer, the §1.1275–6 hedge is not treated as an intercompany transaction for purposes of §1.1502–13. If the taxpayer legs out of integrated treatment, the taxpayer and the counterparty are each treated as disposing of its position in the §1.1275–6 hedge under the principles of paragraph (d)(2) of this section. If the §1.1275–6 hedge remains in existence after the leg-out date, the §1.1275–6 hedge is treated under the rules that would otherwise apply to the transaction (including §1.1502–13 if the transaction is between members).

(g) *Predecessors and successors.* For purposes of this section, any reference to a taxpayer, holder, issuer, or person includes, where appropriate, a reference to a predecessor or successor. For purposes of the preceding sentence, a predecessor is a transferor of an asset or liability (including an integrated transaction) to a transferee (the successor) in a nonrecognition transaction. Appropriate adjustments, if necessary, are made in the application of this section to predecessors and successors.

(h) *Examples.* The following examples illustrate the provisions of this section. In each example, assume that the qualifying debt instrument is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the debt instrument is a debt instrument for Federal income tax purposes.

Example 1. Issuer hedge. (i) *Facts.* On January 1, 1997, V, a domestic corporation, issues a 5-year debt instrument for $1,000. The debt instrument provides for annual payments of interest at a rate equal to the value of 1-year LIBOR and a principal payment of $1,000 at maturity. On the same day, V enters into a 5-year interest rate swap agreement with an unrelated party. Under the swap, V pays 6 percent and receives 1-year LIBOR on a notional principal amount of $1,000. The payments on the swap are fixed and made on the same days as the payments on the debt instrument. On January 1, 1997, V identifies the debt instrument and the swap as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* The debt instrument is a qualifying debt instrument. The swap is a §1.1275–6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the swap and the debt instrument can be calculated. V has met the identification requirements, and the other requirements of paragraph (c)(1) of this section are satisfied. Therefore, the transaction is an integrated transaction under this section.

(iii) *Treatment of the synthetic debt instrument.* The synthetic debt instrument is a 5-year debt instrument that has an issue price of $1,000 and provides for annual interest payments of $60 and a principal payment of $1,000 at maturity. Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(i) of this section, the synthetic debt instrument has a stated redemption price at maturity of $1,300 (the sum of all amounts to be paid on the qualifying debt instrument and the swap, reduced by amounts to be received on the swap). The synthetic debt instrument, therefore, has $300 of OID.

Example 2. Issuer hedge with an option. (i) *Facts.* On December 31, 1996, W, a domestic corporation, issues for $1,000 a debt instrument that matures on December 31, 1999. The debt instrument has a stated principal

amount of $1,000 payable at maturity. The debt instrument also provides for a payment at maturity equal to $10 times the increase, if any, in the value of a nationally known composite index of stocks from December 31, 1996, to the maturity date. On December 31, 1996, W purchases from an unrelated party an option that pays $10 times the increase, if any, in the stock index from December 31, 1996, to December 31, 1999. W pays $250 for the option. On December 31, 1996, W identifies the debt instrument and option as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* The debt instrument is a qualifying debt instrument. The option is a §1.1275–6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the option and the debt instrument can be calculated. W has met the identification requirements, and the other requirements of paragraph (c)(1) of this section are satisfied. Therefore, the transaction is an integrated transaction under this section.

(iii) *Treatment of the synthetic debt instrument.* Under paragraph (f)(4) of this section, the issue price of the synthetic debt instrument is equal to the issue price of the debt instrument ($1,000) reduced by the payment for the option ($250). As a result, the synthetic debt instrument is a 3-year debt instrument with an issue price of $750. Under paragraph (f)(7) of this section, the synthetic debt instrument has a stated redemption price at maturity of $1,000 (the $250 payment for the option is not taken into account). The synthetic debt instrument, therefore, has $250 of OID.

Example 3. Hedge with prepaid swap. (i) *Facts.* On January 1, 1997, H purchases for £1,000 a 5-year debt instrument that provides for semiannual payments based on 6-month pound LIBOR and a payment of the £1,000 principal at maturity. On the same day, H enters into a swap with an unrelated third party under which H receives semiannual payments, in pounds, of 10 percent, compounded semiannually, and makes semiannual payments, in pounds, of 6-month pound LIBOR on a notional principal amount of £1,000. Payments on the swap are fixed and made on the same dates as the payments on the debt instrument. H also makes a £162 prepayment on the swap. On January 1, 1997, H identifies the swap and the debt instrument as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* The debt instrument is a qualifying debt instrument. The swap is a §1.1275–6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the swap and the debt instrument can be calculated. Although the debt instrument is denominated in pounds, the swap hedges only interest rate risk, not currency risk. Therefore, the transaction is an integrated transaction under this section. See §1.988–5(a) for the treatment of a debt instrument and a swap if the swap hedges currency risk.

(iii) *Treatment of the synthetic debt instrument.* Under paragraph (f)(4) of this section, the issue price of the synthetic debt instrument is equal to the issue price of the debt instrument (£1,000) increased by the prepayment on the swap (£162). As a result, the synthetic debt instrument is a 5-year debt instrument that has an issue price of £1,162 and provides for semiannual interest payments of £50 and a principal payment of £1,000 at maturity. Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(ii) of this section, the synthetic debt instrument's stated redemption price at maturity is £1,500 (the sum of all amounts to be received on the qualifying debt instrument and the §1.1275–6 hedge, reduced by all amounts to be paid on the §1.1275–6 hedge other than the £162 prepayment for the swap). The synthetic debt instrument, therefore, has £338 of OID.

Example 4. Legging into an integrated transaction by a holder. (i) *Facts.* On December 31, 1996, X corporation purchases for $1,000,000 a debt instrument that matures on December 31, 2006. The debt instrument provides for annual payments of interest at the rate of 6 percent and for a payment at maturity equal to $1,000,000, increased by the excess, if any, of the price of 1,000 units of a commodity on December 31, 2006, over $350,000, and decreased by the excess, if any, of $350,000 over the price of 1,000 units of the commodity on that date. The projected amount of the payment at maturity determined under §1.1275–4(b)(4) is $1,020,000. On December 31, 1999, X enters into a cash-settled forward contract with an unrelated party to sell 1,000 units of the commodity on December 31, 2006, for $450,000. On December 31, 1999, X also identifies the debt instrument and the forward contract as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* X meets the requirements for integration as of December 31, 1999. Therefore, X legged into an integrated transaction on that date. Prior to that date, X treats the debt instrument under the applicable rules of §1.1275–4.

(iii) *Treatment of the synthetic debt instrument.* As of December 31, 1999, the debt instrument and the forward contract are treated as an integrated transaction. The issue price of the synthetic debt instrument is equal to the adjusted issue price of the qualifying debt instrument on the leg-in date, $1,004,804 (assuming one year accrual periods). The term of the synthetic debt instrument is from December 31, 1999, to December

31, 2006. The synthetic debt instrument provides for annual interest payments of $60,000 and a principal payment at maturity of $1,100,000 ($1,000,000 + $450,000 − $350,000). Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(ii) of this section, the synthetic debt instrument's stated redemption price at maturity is $1,520,000 (the sum of all amounts to be received by X on the qualifying debt instrument and the § 1.1275–6 hedge, reduced by all amounts to be paid by X on the § 1.1275–6 hedge). The synthetic debt instrument, therefore, has $515,196 of OID.

Example 5. Abusive leg-in. (i) *Facts.* On January 1, 1997, Y corporation purchases for $1,000,000 a debt instrument that matures on December 31, 2001. The debt instrument provides for annual payments of interest at the rate of 6 percent, a payment on December 31, 1999, of the increase, if any, in the price of a commodity from January 1, 1997, to December 31, 1999, and a payment at maturity of $1,000,000 and the increase, if any, in the price of the commodity from December 31, 1999 to maturity. Because the debt instrument is a contingent payment debt instrument subject to § 1.1275–4, Y accrues interest based on the projected payment schedule.

(ii) *Leg-in.* By late 1999, the price of the commodity has substantially increased, and Y expects a positive adjustment on December 31, 1999. In late 1999, Y enters into an agreement to exchange the two commodity based payments on the debt instrument for two payments on the same dates of $100,000 each. Y identifies the transaction as an integrated transaction in accordance with the requirements of paragraph (e) of this section. Y disposes of the hedge in early 2000.

(iii) *Treatment.* The legging into an integrated transaction has the effect of deferring the positive adjustment from 1999 to 2000. Because Y legged into the integrated transaction with a principal purpose to defer the positive adjustment, the Commissioner may treat the debt instrument as sold for its fair market value on the leg-in date or refuse to allow integration.

Example 6. Integration of offsetting debt instruments. (i) *Facts.* On January 1, 1997, Z issues two 10-year debt instruments. The first, Issue 1, has an issue price of $1,000, pays interest annually at 6 percent, and, at maturity, pays $1,000, increased by $1 times the increase, if any, in the value of the S&P 100 Index over the term of the instrument and reduced by $1 times the decrease, if any, in the value of the S&P 100 Index over the term of the instrument. However, the amount paid at maturity may not be less than $500 or more than $1,500. The second, Issue 2, has an issue price of $1,000, pays interest annually at 8 percent, and, at maturity, pays $1,000, reduced by $1 times the increase, if any, in the value of the S&P 100 Index over the term of the instrument and increased by $1 times the decrease, if any, in the value of the S&P 100 Index over the term of the instrument. The amount paid at maturity may not be less than $500 or more than $1,500. On January 1, 1997, Z identifies Issue 1 as the qualifying debt instrument, Issue 2 as a § 1.1275–6 hedge, and otherwise meets the identification requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* Both Issue 1 and Issue 2 are qualifying debt instruments. Z has met the identification requirements by identifying Issue 1 as the qualifying debt instrument and Issue 2 as the § 1.1275–6 hedge. The other requirements of paragraph (c)(1) of this section are satisfied. Therefore, the transaction is an integrated transaction under this section.

(iii) *Treatment of the synthetic debt instrument.* The synthetic debt instrument has an issue price of $2,000, provides for a payment at maturity of $2,000, and, in addition, provides for annual payments of $140. Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(i) of this section, the synthetic debt instrument's stated redemption price at maturity is $3,400 (the sum of all amounts to be paid on the qualifying debt instrument and the § 1.1275–6 hedge, reduced by amounts to be received on the § 1.1275–6 hedge other than the $1,000 payment received on the issue date). The synthetic debt instrument, therefore, has $1,400 of OID.

Example 7. Integrated transaction entered into by a foreign person. (i) *Facts.* X, a foreign person, enters into an integrated transaction by purchasing a qualifying debt instrument that pays U.S. source interest and entering into a notional principal contract with a U.S. corporation. Neither the income from the qualifying debt instrument nor the income from the notional principal contract is effectively connected with a U.S. trade or business. The notional principal contract is a § 1.1275–6 hedge.

(ii) *Treatment of integrated transaction.* Under paragraph (f)(8) of this section, X will receive U.S. source income from the integrated transaction. However, under paragraph (f)(12)(i) of this section, the qualifying debt instrument and the notional principal contract are treated as if they are not part of an integrated transaction for purposes of determining whether tax is due and must be withheld on income. Accordingly, because the § 1.1275–6 hedge would produce foreign source income under § 1.863–7 to X if it were not part of an integrated transaction, any income on the § 1.1275–6 hedge generally will not be subject to tax under sections 871(a) and 881, and the U.S. corporation that is the counterparty will not be required to withhold tax on payments under the § 1.1275–6 hedge under sections 1441 and 1442.

(i) [Reserved]

(j) *Effective date*. This section applies to a qualifying debt instrument issued on or after August 13, 1996. This section also applies to a qualifying debt instrument acquired by the taxpayer on or after August 13, 1996, if—

(1) The qualifying debt instrument is a fixed rate debt instrument or a variable rate debt instrument; or

(2) The qualifying debt instrument and the §1.1275–6 hedge are acquired by the taxpayer substantially contemporaneously.

[T.D. 8674, 61 FR 30155, June 14, 1996]

§ 1.1275–7 Inflation-indexed debt instruments.

(a) *Overview*. This section provides rules for the Federal income tax treatment of an inflation-indexed debt instrument. If a debt instrument is an inflation-indexed debt instrument, one of two methods will apply to the instrument: the coupon bond method (as described in paragraph (d) of this section) or the discount bond method (as described in paragraph (e) of this section). Both methods determine the amount of OID that is taken into account each year by a holder or an issuer of an inflation-indexed debt instrument.

(b) *Applicability*—(1) *In general*. Except as provided in paragraph (b)(2) of this section, this section applies to an inflation-indexed debt instrument as defined in paragraph (c)(1) of this section. For example, this section applies to Treasury Inflation-Protected Securities (TIPS).

(2) *Exceptions*. This section does not apply to an inflation-indexed debt instrument that is also—

(i) A debt instrument (other than a tax-exempt obligation) described in section 1272(a)(2) (for example, U.S. savings bonds, certain loans between natural persons, and short-term taxable obligations); or

(ii) A debt instrument subject to section 529 (certain debt instruments issued by qualified state tuition programs).

(c) *Definitions*. The following definitions apply for purposes of this section:

(1) *Inflation-indexed debt instrument*. An inflation-indexed debt instrument is a debt instrument that satisfies the following conditions:

(i) *Issued for cash*. The debt instrument is issued for U.S. dollars and all payments on the instrument are denominated in U.S. dollars.

(ii) *Indexed for inflation and deflation*. Except for a minimum guarantee payment (as defined in paragraph (c)(5) of this section), each payment on the debt instrument is indexed for inflation and deflation. A payment is indexed for inflation and deflation if the amount of the payment is equal to—

(A) The amount that would be payable if there were no inflation or deflation over the term of the debt instrument, multiplied by

(B) A ratio, the numerator of which is the value of the reference index for the date of the payment and the denominator of which is the value of the reference index for the issue date.

(iii) *No other contingencies*. No payment on the debt instrument is subject to a contingency other than the inflation contingency or the contingencies described in this paragraph (c)(1)(iii). A debt instrument may provide for—

(A) A minimum guarantee payment as defined in paragraph (c)(5) of this section; or

(B) Payments under one or more alternate payment schedules if the payments under each payment schedule are indexed for inflation and deflation and a payment schedule for the debt instrument can be determined under §1.1272–1(c). (For purposes of this section, the rules of §1.1272–1(c) are applied to the debt instrument by assuming that no inflation or deflation will occur over the term of the instrument.)

(2) *Reference index*. The reference index is an index used to measure inflation and deflation over the term of a debt instrument. To qualify as a reference index, an index must satisfy the following conditions:

(i) The value of the index is reset once a month to a current value of a single qualified inflation index (as defined in paragraph (c)(3) of this section). For this purpose, a value of a qualified inflation index is current if the value has been updated and published within the preceding six month period.

(ii) The reset occurs on the same day of each month (the reset date).

(iii) The value of the index for any date between reset dates is determined through straight-line interpolation.

(3) *Qualified inflation index.* A qualified inflation index is a general price or wage index that is updated and published at least monthly by an agency of the United States Government (for example, the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U), which is published by the Bureau of Labor Statistics of the Department of Labor).

(4) *Inflation-adjusted principal amount.* For any date, the inflation-adjusted principal amount of an inflation-indexed debt instrument is an amount equal to—

(i) The outstanding principal amount of the debt instrument (determined as if there were no inflation or deflation over the term of the instrument), multiplied by

(ii) A ratio, the numerator of which is the value of the reference index for the date and the denominator of which is the value of the reference index for the issue date.

(5) *Minimum guarantee payment.* In general, a minimum guarantee payment is an additional payment made at maturity on a debt instrument if the total amount of inflation-adjusted principal paid on the instrument is less than the instrument's stated principal amount. The amount of the additional payment must be no more than the excess, if any, of the debt instrument's stated principal amount over the total amount of inflation-adjusted principal paid on the instrument. An additional payment is not a minimum guarantee payment unless the qualified inflation index used to determine the reference index is either the CPI-U or an index designated for this purpose by the Commissioner in the FEDERAL REGISTER or the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter). See paragraph (f)(4) of this section for the treatment of a minimum guarantee payment.

(d) *Coupon bond method*—(1) *In general.* This paragraph (d) describes the method (coupon bond method) to be used to account for qualified stated interest and inflation adjustments (OID) on an inflation-indexed debt instrument described in paragraph (d)(2) of this section.

(2) *Applicability.* The coupon bond method applies to an inflation-indexed debt instrument that satisfies the following conditions:

(i) *Issued at par.* The debt instrument is issued at par. A debt instrument is issued at par if the difference between its issue price and principal amount for the issue date is less than the de minimis amount. For this purpose, the de minimis amount is determined using the principles of §1.1273–1(d). See paragraph (g)(2) of this section, however, for the treatment of TIPS issued with more than a de minimis amount of premium.

(ii) *All stated interest is qualified stated interest.* All stated interest on the debt instrument is qualified stated interest. For purposes of this paragraph (d), stated interest is qualified stated interest if the interest is unconditionally payable in cash, or is constructively received under section 451, at least annually at a single fixed rate. Stated interest is payable at a single fixed rate if the amount of each interest payment is determined by multiplying the inflation adjusted principal amount for the payment date by the single fixed rate.

(3) *Qualified stated interest.* Under the coupon bond method, qualified stated interest is taken into account under the taxpayer's regular method of accounting. The amount of accrued but unpaid qualified stated interest as of any date is determined by using the principles of §1.446–3(e)(2)(ii) (relating to notional principal contracts). For example, if the interval between interest payment dates spans two taxable years, a taxpayer using an accrual method of accounting determines the amount of accrued qualified stated interest for the first taxable year by reference to the inflation-adjusted principal amount at the end of the first taxable year.

(4) *Inflation adjustments*—(i) *Current accrual.* Under the coupon bond method, an inflation adjustment is taken into account for each taxable year in which the debt instrument is outstanding.

(ii) *Amount of inflation adjustment.* For any relevant period (such as the taxable year or the portion of the taxable year during which a taxpayer holds an inflation-indexed debt instrument), the amount of the inflation adjustment is equal to—

(A) The sum of the inflation-adjusted principal amount at the end of the period and the principal payments made during the period, minus

(B) The inflation-adjusted principal amount at the beginning of the period.

(iii) *Positive inflation adjustments.* A positive inflation adjustment is OID.

(iv) *Negative inflation adjustments.* A negative inflation adjustment is a deflation adjustment that is taken into account under the rules of paragraph (f)(1) of this section.

(5) *Example.* The following example illustrates the coupon bond method:

Example: (i) *Facts.* On October 15, 1997, X purchases at original issue, for $100,000, a debt instrument that is indexed for inflation and deflation. The debt instrument matures on October 15, 1999, has a stated principal amount of $100,000, and has a stated interest rate of 5 percent, compounded semiannually. The debt instrument provides that the principal amount is indexed to the CPI-U. Interest is payable on April 15 and October 15 of each year. The amount of each interest payment is determined by multiplying the inflation-adjusted principal amount for each interest payment date by the stated interest rate, adjusted for the length of the accrual period. The debt instrument provides for a single payment of the inflation-adjusted principal amount at maturity. In addition, the debt instrument provides for an additional payment at maturity equal to the excess, if any, of $100,000 over the inflation-adjusted principal amount at maturity. X uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year.

(ii) *Indexing methodology.* The debt instrument provides that the inflation-adjusted principal amount for any day is determined by multiplying the principal amount of the instrument for the issue date by a ratio, the numerator of which is the value of the reference index for the day the inflation-adjusted principal amount is to be determined and the denominator of which is the value of the reference index for the issue date. The value of the reference index for the first day of a month is the value of the CPI-U for the third preceding month. The value of the reference index for any day other than the first day of a month is determined based on a straight-line interpolation between the value of the reference index for the first day of the month and the value of the reference index for the first day of the next month.

(iii) *Inflation-indexed debt instrument subject to the coupon bond method.* Under paragraph (c)(1) of this section, the debt instrument is an inflation-indexed debt instrument. Because there is no difference between the debt instrument's issue price ($100,000) and its principal amount for the issue date ($100,000) and because all stated interest is qualified stated interest, the coupon bond method applies to the instrument.

(iv) *Reference index values.* Assume the following table lists the relevant reference index values for 1997 through 1999:

Date	Reference index value
Oct. 15, 1997	100
Jan. 1, 1998	101
Apr. 15, 1998	103
Oct. 15, 1998	105
Jan. 1, 1999	99

(v) *Treatment of X in 1997.* X does not receive any payments of interest on the debt instrument in 1997. Therefore, X has no qualified stated interest income for 1997. X, however, must take into account the inflation adjustment for 1997. The inflation-adjusted principal amount for January 1, 1998, is $101,000 ($100,000 × 101/100). Therefore, the inflation adjustment for 1997 is $1,000, the inflation-adjusted principal amount for January 1, 1998 ($101,000) minus the principal amount for the issue date ($100,000). X includes the $1,000 inflation adjustment in income as OID in 1997.

(vi) *Treatment of X in 1998.* In 1998, X receives two payments of interest: On April 15, 1998, X receives a payment of $2,575 ($100,000 × 103/100 × .05/2), and on October 15, 1998, X receives a payment of $2,625 ($100,000 × 105/100 × .05/2). Therefore, X's qualified stated interest income for 1998 is $5,200 ($2,575 + $2,625). X also must take into account the inflation adjustment for 1998. The inflation-adjusted principal amount for January 1, 1999, is $99,000 ($100,000 × 99/100). Therefore, the inflation adjustment for 1998 is negative $2,000, the inflation-adjusted principal amount for January 1, 1999 ($99,000) minus the inflation-adjusted principal amount for January 1, 1998 ($101,000). Because the amount of the inflation adjustment is negative, it is a deflation adjustment. Under paragraph (f)(1)(i) of this section, X uses this $2,000 deflation adjustment to reduce the interest otherwise includible in income by X with respect to the debt instrument in 1998. Therefore, X includes $3,200 in income for 1998, the qualified stated interest income for 1998 ($5,200) minus the deflation adjustment ($2,000).

(e) *Discount bond method*—(1) *In general.* This paragraph (e) describes the method (discount bond method) to be

used to account for OID on an inflation-indexed debt instrument that does not qualify for the coupon bond method.

(2) *No qualified stated interest*. Under the discount bond method, no interest on an inflation-indexed debt instrument is qualified stated interest.

(3) *OID*. Under the discount bond method, the amount of OID that accrues on an inflation-indexed debt instrument is determined as follows:

(i) *Step one: Determine the debt instrument's yield to maturity*. The yield of the debt instrument is determined under the rules of § 1.1272–1(b)(1)(i). In calculating the yield under those rules for purposes of this paragraph (e)(3)(i), the payment schedule of the debt instrument is determined as if there were no inflation or deflation over the term of the instrument.

(ii) *Step two: Determine the accrual periods*. The accrual periods are determined under the rules of § 1.1272–1(b)(1)(ii). However, no accrual period can be longer than 1 month.

(iii) *Step three: Determine the percentage change in the reference index during the accrual period*. The percentage change in the reference index during the accrual period is equal to—

(A) The ratio of the value of the reference index at the end of the period to the value of the reference index at the beginning of the period,

(B) Minus one.

(iv) *Step four: Determine the OID allocable to each accrual period*. The OID allocable to an accrual period (n) is determined by using the following formula:

$$OID(_{(n)} = AIP_{(n)} \times [r + inf_{(n)} + (r \times inf_{(n)})]$$

in which,

r = yield of the debt instrument as determined under paragraph (e)(3)(i) of this section (adjusted for the length of the accrual period);

$inf_{(n)}$ = percentage change in the value of the reference index for period (n) as determined under paragraph (e)(3)(iii) of this section; and

$AIP_{(n)}$ = adjusted issue price at the beginning of period (n).

(v) *Step five: Determine the daily portions of OID*. The daily portions of OID are determined and taken into account under the rules of § 1.1272–1(b)(1)(iv). If the daily portions determined under this paragraph (e)(3)(v) are negative amounts, however, these amounts (deflation adjustments) are taken into account under the rules for deflation adjustments described in paragraph (f)(1) of this section.

(4) *Example*. The following example illustrates the discount bond method:

Example: (i) *Facts*. On November 15, 1997, X purchases at original issue, for $91,403, a zero-coupon debt instrument that is indexed for inflation and deflation. The principal amount of the debt instrument for the issue date is $100,000. The debt instrument provides for a single payment on November 15, 2000. The amount of the payment will be determined by multiplying $100,000 by a fraction, the numerator of which is the CPI-U for September 2000, and the denominator of which is the CPI-U for September 1997. The debt instrument also provides that in no event will the payment on November 15, 2000, be less than $100,000. X uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year.

(ii) *Inflation-indexed debt instrument*. Under paragraph (c)(1) of this section, the instrument is an inflation-indexed debt instrument. The debt instrument's principal amount for the issue date ($100,000) exceeds its issue price ($91,403) by $8,597, which is more than the de minimis amount for the debt instrument ($750). Therefore, the coupon bond method does not apply to the debt instrument. As a result, the discount bond method applies to the debt instrument.

(iii) *Yield and accrual period*. Assume X chooses monthly accrual periods ending on the 15th day of each month. The yield of the debt instrument is determined as if there were no inflation or deflation over the term of the instrument. Therefore, based on the issue price of $91,403 and an assumed payment at maturity of $100,000, the yield of the debt instrument is 3 percent, compounded monthly.

(iv) *Percentage change in reference index*. Assume that the CPI-U for September 1997 is 160; for October 1997 is 161.2; and for November 1997 is 161.7. The value of the reference index for November 15, 1997, is 160, the value of the CPI-U for September 1997. Similarly, the value of the reference index for December 15, 1997, is 161.2, and for January 15, 1998, is 161.7. The percentage change in the reference index from November 15, 1997, to December 15, 1997, (inf_1) is 0.0075 (161.2/160–1); the percentage change in the reference index from December 15, 1997, to January 15, 1998, (inf_2) is 0.0031 (161.7/161.2–1).

(v) *Treatment of X in 1997*. For the accrual period ending on December 15, 1997, r is .0025 (.03/12), inf_1 is .0075, and the product of r and inf_1 is .00001875. Under paragraph (e)(3) of this

section, the amount of OID allocable to the accrual period ending on December 15, 1997, is $916. This amount is determined by multiplying the issue price of the debt instrument ($91,403) by .01001875 (the sum of r, inf_1, and the product of r and inf_1). The adjusted issue price of the debt instrument on December 15, 1997, is $92,319 ($91,403 + $916). For the accrual period ending on January 15, 1998, r is .0025 (.03/12), inf_2 is .0031, and the product of r and inf_2 is .00000775. Under paragraph (e)(3) of this section, the amount of OID allocable to the accrual period ending on January 15, 1998, is $518. This amount is determined by multiplying the adjusted issue price of the debt instrument ($92,319) by .00560775 (the sum of r, inf_2, and the product of r and inf_2). Because the accrual period ending on January 15, 1998, spans two taxable years, only $259 of this amount ($518/30 days × 15 days) is allocable to 1997. Therefore, X includes $1,175 of OID in income for 1997 ($916 + $259).

(f) *Special rules*. The following rules apply to an inflation-indexed debt instrument:

(1) *Deflation adjustments*—(i) *Holder*. A deflation adjustment reduces the amount of interest otherwise includible in income by a holder with respect to the debt instrument for the taxable year. For purposes of this paragraph (f)(1)(i), interest includes OID, qualified stated interest, and market discount. If the amount of the deflation adjustment exceeds the interest otherwise includible in income by the holder with respect to the debt instrument for the taxable year, the excess is treated as an ordinary loss by the holder for the taxable year. However, the amount treated as an ordinary loss is limited to the amount by which the holder's total interest inclusions on the debt instrument in prior taxable years exceed the total amount treated by the holder as an ordinary loss on the debt instrument in prior taxable years. If the deflation adjustment exceeds the interest otherwise includible in income by the holder with respect to the debt instrument for the taxable year and the amount treated as an ordinary loss for the taxable year, this excess is carried forward to reduce the amount of interest otherwise includible in income by the holder with respect to the debt instrument for subsequent taxable years.

(ii) *Issuer*. A deflation adjustment reduces the interest otherwise deductible by the issuer with respect to the debt instrument for the taxable year. For purposes of this paragraph (f)(1)(ii), interest includes OID and qualified stated interest. If the amount of the deflation adjustment exceeds the interest otherwise deductible by the issuer with respect to the debt instrument for the taxable year, the excess is treated as ordinary income by the issuer for the taxable year. However, the amount treated as ordinary income is limited to the amount by which the issuer's total interest deductions on the debt instrument in prior taxable years exceed the total amount treated by the issuer as ordinary income on the debt instrument in prior taxable years. If the deflation adjustment exceeds the interest otherwise deductible by the issuer with respect to the debt instrument for the taxable year and the amount treated as ordinary income for the taxable year, this excess is carried forward to reduce the interest otherwise deductible by the issuer with respect to the debt instrument for subsequent taxable years. If there is any excess remaining upon the retirement of the debt instrument, the issuer takes the excess amount into account as ordinary income.

(2) *Adjusted basis*. A holder's adjusted basis in an inflation-indexed debt instrument is determined under § 1.1272–1(g). However, a holder's adjusted basis in the debt instrument is decreased by the amount of any deflation adjustment the holder takes into account to reduce the amount of interest otherwise includible in income or treats as an ordinary loss with respect to the instrument during the taxable year. The decrease occurs when the deflation adjustment is taken into account under paragraph (f)(1) of this section.

(3) *Subsequent holders*. A holder determines the amount of acquisition premium or market discount on an inflation-indexed debt instrument by reference to the adjusted issue price of the instrument on the date the holder acquires the instrument. A holder determines the amount of bond premium on an inflation-indexed debt instrument by assuming that the amount payable at maturity on the instrument is equal to the instrument's inflation-adjusted principal amount for the day the holder acquires the instrument. Any premium or market discount is

taken into account over the remaining term of the debt instrument as if there were no further inflation or deflation. See section 171 for additional rules relating to the amortization of bond premium and sections 1276 through 1278 for additional rules relating to market discount.

(4) *Minimum guarantee.* Under both the coupon bond method and the discount bond method, a minimum guarantee payment is ignored until the payment is made. If there is a minimum guarantee payment, the payment is treated as interest on the date it is paid.

(5) *Temporary unavailability of a qualified inflation index.* Notwithstanding any other rule of this section, an inflation-indexed debt instrument may provide for a substitute value of the qualified inflation index if and when the publication of the value of the qualified inflation index is temporarily delayed. The substitute value may be determined by the issuer under any reasonable method. For example, if the CPI-U is not reported for a particular month, the debt instrument may provide that a substitute value may be determined by increasing the last reported value by the average monthly percentage increase in the qualified inflation index over the preceding twelve months. The use of a substitute value does not result in a reissuance of the debt instrument.

(g) *TIPS*—(1) *Reopenings.* For rules concerning a reopening of TIPS, see paragraphs (d)(2), (k)(3)(iii), and (k)(3)(v) of § 1.1275–2.

(2) *TIPS issued with more than a de minimis amount of premium*—(i) *Coupon bond method.* Notwithstanding paragraph (d)(2)(i) of this section, the coupon bond method described in paragraph (d) of this section applies to TIPS issued with more than a de minimis amount of premium. For this purpose, the de minimis amount is determined using the principles of § 1.1273–1(d).

(ii) *Example.* The following example illustrates the application of the bond premium rules to a TIPS issued with bond premium:

Example. (i) *Facts.* X, a calendar year taxpayer, purchases at original issuance TIPS with a stated principal amount of $100,000 and a stated interest rate of .125 percent, compounded semiannually. For purposes of this example, assume that the TIPS are issued in Year 1 on January 1, stated interest is payable on June 30 and December 31 of each year, and that the TIPS mature on December 31, Year 5. X pays $102,000 for the TIPS, which is the issue price for the TIPS as determined under § 1.1275–2(d)(1). Assume that the inflation-adjusted principal amount for the first coupon in Year 1 is $101,225 (resulting in an interest payment of $63.27) and for the second coupon in Year 1 is $102,500 (resulting in an interest payment of $64.06). X elects to amortize bond premium under § 1.171–4. (For simplicity, contrary to actual practice, the TIPS in this example were issued on the date with respect to which the calculation of the first coupon began.)

(ii) *Bond premium.* The stated interest on the TIPS is qualified stated interest under § 1.1273–1(c). X acquired the TIPS with bond premium of $2,000 (basis of $102,000 minus the TIPS' stated principal amount of $100,000). *See* §§ 1.171–1(d), 1.171–3(b), and paragraph (f)(3) of this section. The $2,000 is more than the de minimis amount of premium for the TIPS of $1,250 (.0025 times the stated principal amount of the TIPS ($100,000) times the number of complete years to the TIPS' maturity (5 years)). Under paragraph (g)(2)(i) of this section, X must use the coupon bond method to determine X's income from the TIPS.

(iii) *Allocation of bond premium.* Under § 1.171–3(b), the bond premium of $2,000 is allocable to each semiannual accrual period by assuming that there will be no inflation or deflation over the term of the TIPS. Moreover, for purposes of § 1.171–2, the yield of the securities is determined by assuming that there will be no inflation or deflation over their term. Based on this assumption, for purposes of section 171, the TIPS provide for semiannual interest payments of $62.50 and a $100,000 payment at maturity. As a result, the yield of the securities for purposes of section 171 is −0.2720 percent, compounded semiannually. Under § 1.171–2, the bond premium allocable to an accrual period is the excess of the qualified stated interest allocable to the accrual period ($62.50 for each accrual period) over the product of the taxpayer's adjusted acquisition price at the beginning of the accrual period (determined without regard to any inflation or deflation) and the taxpayer's yield. Therefore, the $2,000 of bond premium is allocable to each semiannual accrual period in Year 1 as follows: $201.22 to the accrual period ending on June 30, Year 1 (the excess of the stated interest of $62.50 over ($102,000 × −0.002720/2)); and $200.95 to the accrual period ending on December 31, Year 1 (the excess of the stated interest of $62.50 over ($101,798.78 × −0. 002720/

2)). The adjusted acquisition price at the beginning of the accrual period ending on December 31, Year 1 is $101,798.78 (the adjusted acquisition price of $102,000 at the beginning of the accrual period ending on June 30, Year 1 reduced by the $201.22 of premium allocable to that accrual period).

(iv) *Income determined by applying the coupon bond method and the bond premium rules.* Under paragraph (d)(4) of this section, the application of the coupon bond method to the TIPS results in a positive inflation adjustment in Year 1 of $2,500, which is includible in X's income for Year 1. However, because X acquired the TIPS at a premium and elected to amortize the premium, the premium allocable to Year 1 will offset the income on the TIPS as follows: The premium allocable to the first accrual period of $201.22 first offsets the interest payable for that period of $63.27. The remaining $137.95 of premium is treated as a deflation adjustment that offsets the positive inflation adjustment. *See* § 1.171–3(b). The premium allocable to the second accrual period of $200.95 first offsets the interest payable for that period of $64.06. The remaining $136.89 of premium is treated as a deflation adjustment that further offsets the positive inflation adjustment. As a result, X does not include in income any of the stated interest received in Year 1 and includes in Year 1 income only $2,225.16 of the positive inflation adjustment for Year 1 ($2,500 − $137.94 − $136.89).

(h) *Effective/applicability dates*—(1) *In general.* This section applies to an inflation-indexed debt instrument issued on or after January 6, 1997.

(2) *TIPS issued with more than a de minimis amount of premium.* Notwithstanding paragraph (h)(1) of this section, paragraph (g)(2) of this section applies to TIPS issued with more than a de minimis amount of premium on or after April 8, 2011.

[T.D. 8709, 62 FR 618, Jan. 6, 1997. Redesignated by T.D. 8838, 64 FR 48547, Sept. 7, 1999, as amended by T.D. 8840, 64 FR 60343, Nov. 5, 1999; T.D. 8934, 66 FR 2817, Jan. 12, 2001; T.D. 9609, 78 FR 668, Jan. 4, 2013]

§ 1.1286–1 Tax treatment of certain stripped bonds and stripped coupons.

(a) *De minimis OID.* If the original issue discount determined under section 1286(a) with respect to the purchase of a stripped bond or stripped coupon is less than the amount computed under subparagraphs (A) and (B) of section 1273(a)(3) and the regulations thereunder, then the amount of original issue discount with respect to that purchase (other than any tax-exempt portion thereof, determined under section 1286(d)(2)) shall be considered to be zero. For purposes of this computation, the number of complete years to maturity is measured from the date the stripped bond or stripped coupon is purchased.

(b) *Treatment of certain stripped bonds as market discount bonds*—(1) *In general.* By publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of the Statement of Procedural Rules), the Internal Revenue Service may (subject to the limitation of paragraph (b)(2) of this section) provide that certain mortgage loans that are stripped bonds are to be treated as market discount bonds under section 1278. Thus, any purchaser of such a bond is to account for any discount on the bond as market discount rather than original issue discount.

(2) *Limitation.* This treatment may be provided for a stripped bond only if, immediately after the most recent disposition referred to in section 1286(b)—

(i) The amount of original issue discount with respect to the stripped bond is determined under paragraph (a) of this section (concerning *de minimis* OID); or

(ii) The annual stated rate of interest payable on the stripped bond is no more than 100 basis points lower than the annual stated rate of interest payable on the original bond from which it and any other stripped bond or bonds and any stripped coupon or coupons were stripped.

(c) *Effective date.* This section is effective on and after August 8, 1991.

[T.D. 8463, 57 FR 61812, Dec. 29, 1992]

§ 1.1286–2 Stripped inflation-protected debt instruments.

Stripped inflation-protected debt instruments. If a Treasury Inflation-Protected Security is stripped under the Department of the Treasury's Separate Trading of Registered Interest and Principal of Securities (STRIPS) program, the holders of the principal and coupon components must use the discount bond method (as described in

§ 1.1275–7(e)) to account for the original issue discount on the components.

[T.D. 8709, 62 FR 621, Jan. 6, 1997. Redesignated by T.D. 8838, 64 FR 48547, Sept. 7, 1999; T.D. 9609, 78 FR 668, Jan. 4, 2013]

§ 1.1287–1 Denial of capital gains treatment for gains on registration-required obligations not in registered form.

(a) *In general*. Except as provided in paragraph (c) of this section, any gain on the sale or other disposition of a registration-required obligation held after December 31, 1982, that is not in registered form shall be treated as ordinary income unless the issuance of the obligation was subject to tax under section 4701. The term *registration-required obligation* has the meaning given to that term in section 163(f)(2), except that clause (iv) of subparagraph (A) thereof shall not apply. Therefore, although an obligation that is not in registered form is described in § 1.163–5(c)(1), the holder of such an obligation shall be required to treat the gain on the sale or other disposition of such obligation as ordinary income. The term *holder* means the person that would be denied a loss deduction under section 165(j)(1) or denied capital gain treatment under section 1287(a).

(b) *Registered form*—(1) *Obligations issued after September 21, 1984*. With respect to any obligation originally issued after September 21, 1984, the term *registered form* has the meaning given that term in section 103(j)(3) and the regulations thereunder. Therefore, an obligation that would otherwise be in registered form is not considered to be in registered form if it can be transferred at that time or at any time until its maturity by any means not described in § 5f.103–1(c). An obligation that, as of a particular time, is not considered to be in registered form because it can be transferred by any means not described in § 5f.103–1(c) is considered to be in registered form at all times during the period beginning with a later time and ending with the maturity of the obligation in which the obligation can be transferred only by a means described in § 5f.103–1(c).

(2) *Obligations issued after December 31, 1982, and on or before September 21, 1984*. With respect to any obligation originally issued after December 31, 1982, and on or before September 21, 1984, or an obligation originally issued after September 21, 1984, pursuant to the exercise of a warrant or the conversion of a convertible obligation, which warrant or obligation (including conversion privilege) was issued after December 31, 1982, and on or before September 21, 1984, that obligation will be considered to be in registered form if it satisfied § 5f.163–1 or the proposed regulations provided in § 1.163.–5(c) and published in the FEDERAL REGISTER on September 2, 1983 (48 FR 39953).

(c) *Registration-required obligations not in registered form which are not subject to section 1287(c)*. Notwithstanding the fact than an obligation is a registration-required obligation that is not in registered form, the holder will not be subject to section 1287(a) if the holder meets the conditions of § 1.165–12(c).

(d) *Effective date*. These regulations apply generally to obligations issued after January 20, 1987. However, a taxpayer may choose to apply the rules of § 1.1287–1 with respect to an obligation issued after December 31, 1982, and on or before January 20, 1987, which obligation is held after January 20, 1987.

[T.D. 8110, 51 FR 45461, Dec. 19, 1986]

§ 1.1288–1 Adjustment of applicable Federal rate for tax-exempt obligations.

(a) *In general*. In applying section 483 or section 1274 to a tax-exempt obligation, the applicable Federal rate is adjusted to take into account the tax exemption for interest on the obligation. For each applicable Federal rate determined under section 1274(d), the Secretary computes a corresponding adjusted applicable Federal rate by multiplying the applicable Federal rate by the adjustment factor described in paragraph (b) of this section. The Internal Revenue Service publishes the applicable Federal rates and the adjusted applicable Federal rates for each month in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter).

(b) *Adjustment factor*. The adjustment factor is a percentage equal to—

(1) The excess of 100 percent, over

(2) The product of—

(i) 59 percent, and

(ii) The sum of the maximum rate in effect under section 1 applicable to individuals and the maximum rate in effect under section 1411 applicable to individuals for the month to which the adjusted applicable Federal rate applies.

(c) *Effective/applicability date.* The rules of this section apply to the determination of adjusted applicable Federal rates beginning with the rates determined during August 2016 that apply during September 2016.

[T.D. 9763, 81 FR 24484, Apr. 26, 2016]

§ 1.1291–0 Treatment of shareholders of certain passive foreign investment companies; table of contents.

This section contains a listing of the headings for §§ 1.1291–1, 1.1291–9, and 1.1291–10.

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§ 1.1291–10 Deemed sale election.

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(i) Effective date.

[T.D. 8701, 61 FR 68151, Dec. 27, 1996, as amended by T.D. 8750, 63 FR 13, Jan. 2, 1998; T.D. 9123, 69 FR 24073, May 3, 2004; T.D. 9806, 81 FR 95465, Dec. 28, 2016; T.D. 9936, 86 FR 4555, Jan. 15, 2021]

§ 1.1291–1 Taxation of U.S. persons that are shareholders of section 1291 funds.

(a) through (b)(2)(i) [Reserved]

(ii) *Pedigreed QEF*. A PFIC is a *pedigreed QEF* with respect to a shareholder if the PFIC has been a QEF with respect to the shareholder for all taxable years during which the corporation was a PFIC that are included wholly or partly in the shareholder's holding period of the PFIC stock.

(b)(2)(iii) and (iv) [Reserved]

(v) *Section 1291 fund*. A PFIC is a *section 1291 fund* with respect to a shareholder unless the PFIC is a pedigreed QEF with respect to the shareholder or a section 1296 election is in effect with respect to the shareholder.

(3) through (6) [Reserved]

(7) *Shareholder*. A *shareholder* is a United States person that directly owns stock of a PFIC (a direct shareholder), or that is an indirect shareholder (as defined in section 1298(a) and paragraph (b)(8) of this section), except as provided in paragraph (e) of this section. For purposes of sections 1291 and 1298, a domestic partnership or S corporation (as defined in section 1361(a)(1)) is not treated as a shareholder of a PFIC except for purposes of any information reporting requirements, including the requirement to file an annual report under section 1298(f). In addition, to the extent that a person is treated under sections 671 through 678 as the owner of a portion of a domestic trust, the trust is not treated as a shareholder of a PFIC with respect to PFIC stock held by that portion of the trust, except for purposes of the information reporting requirements of § 1.1298–1(b)(3)(i) (imposing an information reporting requirement on domestic liquidating trusts and fixed investment trusts).

(8) *Indirect shareholder*—(i) *In general*. An *indirect shareholder* of a PFIC is a United States person that indirectly owns stock of a PFIC. A person indirectly owns stock when it is treated as owning stock of a corporation owned by another person, including another United States person, under this paragraph (b)(8). In applying this paragraph (b)(8), the determination of a person's indirect ownership is made on the basis of all the facts and circumstances in each case; the substance rather than the form of ownership is controlling, taking into account the purposes of sections 1291 through 1298.

(ii) *Ownership through a corporation*—(A) *Ownership through a non-PFIC foreign corporation*. A person that directly or indirectly owns 50 percent or more in value of the stock of a foreign corporation that is not a PFIC is considered to own a proportionate amount (by value) of any stock owned directly or indirectly by the foreign corporation.

(B) *Ownership through a PFIC*. A person that directly or indirectly owns stock of a PFIC is considered to own a proportionate amount (by value) of any stock owned directly or indirectly by the PFIC. Section 1297(d) does not apply in determining whether a corporation is a PFIC for purposes of this paragraph (b)(8)(ii)(B).

(C) *Ownership through a domestic corporation*—(*1*) *In general*. Solely for purposes of determining whether a person satisfies the ownership threshold described in paragraph (b)(8)(ii)(A) of this section, a person that directly or indirectly owns 50 percent or more in value of the stock of a domestic corporation is considered to own a proportionate amount (by value) of any stock owned directly or indirectly by the domestic corporation.

(*2*) *Non-duplication*. Paragraph (b)(8)(ii)(C)(*1*) of this section does not apply to treat a United States person as owning (other than for purposes of applying the ownership threshold in paragraph (b)(8)(ii)(A) of this section) stock of a PFIC that is directly owned or considered owned indirectly within the meaning of this paragraph (b)(8) by

another United States person (determined without regard to paragraph (b)(8)(ii)(C)(*1*)). See *Example 1* of paragraph (b)(8)(iv) of this section.

(*3*) *S corporations*. The 50 percent limitation in paragraph (b)(8)(ii)(C)(*1*) of this section does not apply with respect to stock owned directly or indirectly by an S corporation. See paragraph (b)(8)(iii)(B) of this section for rules regarding stock owned directly or indirectly by an S corporation.

(iii) *Ownership through pass-through entities*—(A) *Partnerships*. If a foreign or domestic partnership directly or indirectly owns stock, the partners of the partnership are considered to own such stock proportionately in accordance with their ownership interests in the partnership.

(B) *S Corporations*. If an S corporation directly or indirectly owns stock, each S corporation shareholder is considered to own such stock proportionately in accordance with the shareholder's ownership interest in the S corporation.

(C) *Estates and nongrantor trusts*. If a foreign or domestic estate or nongrantor trust (other than an employees' trust described in section 401(a) that is exempt from tax under section 501(a)) directly or indirectly owns stock, each beneficiary of the estate or trust is considered to own a proportionate amount of such stock. For purposes of this paragraph (b)(8)(iii)(C), a nongrantor trust is any trust or portion of a trust that is not treated as owned by one or more persons under sections 671 through 679.

(D) *Grantor trusts*. If a foreign or domestic trust directly or indirectly owns stock, a person that is treated under sections 671 through 679 as the owner of any portion of the trust that holds an interest in the stock is considered to own the interest in the stock held by that portion of the trust.

(iv) *Successive application*. Stock considered to be owned by a person by reason of paragraphs (b)(8)(ii) or (iii) of this section is, for purposes of applying such paragraphs, considered to be actually owned by such person. Subject to the limitations provided in section 1298(a) and paragraphs (b)(8)(ii) and (b)(8)(iii) of this section, this paragraph applies by successively considering a person as actually owning its proportionate share of stock or other equity interest directly held by an entity directly owned by the person. Paragraph (b)(8)(ii)(C)(*2*) of this section applies after the other subparagraphs of paragraph (b)(8) of this section.

(v) *Examples*. The rules of this paragraph (b)(8) are illustrated by the following examples:

(A) *Example 1*—(*1*) *Facts*. A is a United States person who owns 49% of the stock of FC1, a foreign corporation that is not a PFIC, and separately all of the stock of DC, a domestic corporation that is not an S corporation. DC, in turn, owns the remaining 51% of the stock of FC1, and FC1 owns 100 shares of stock in a PFIC that is not a controlled foreign corporation (CFC) within the meaning of section 957(a). The remainder of the PFIC's shares are owned by unrelated foreign persons.

(*2*) *Results*—(*i*) *Treatment of DC*. Under paragraph (b)(8)(ii)(A) of this section, DC is considered to actually own 51 shares of the PFIC stock directly held by FC1 because DC directly owns 50% or more of the stock of FC1.

(*ii*) *Treatment of A*. In determining whether A is considered to own 50% or more of the value of FC1 for purposes of applying paragraphs (b)(8)(ii)(A) and (b)(8)(iv) of this section to the PFIC stock held through FC1, A is considered under paragraphs (b)(8)(ii)(C)(*1*) and (b)(8)(iv) of this section as indirectly owning all the stock of FC1 that DC directly owns, before the application of paragraph (b)(8)(ii)(C)(*2*) of this section. Because A also directly owns 49% of the stock of FC1, before the application of paragraph (b)(8)(ii)(C)(*2*) of this section A would be treated as owning all 100 shares of PFIC stock held by FC1. However, because 51 shares of the PFIC stock held by FC1 are indirectly owned by DC under paragraph (b)(8)(ii)(A) of this section, pursuant to the limitation imposed by paragraph (b)(8)(ii)(C)(*2*) of this section, only the remaining 49 shares of the PFIC stock are considered as indirectly owned by A under paragraph (b)(8) of this section.

(B) *Example 2*—(*1*) *Facts*. B, a United States citizen, owns 50% of the interests in Foreign Partnership, a foreign partnership treated as a partnership for U.S. federal income tax purposes,

the remaining interests in which are owned by an unrelated foreign person. Foreign Partnership owns 100% of the stock of FC1 and 50% of the stock of FC2, the remainder of which is owned by an unrelated foreign person. Both FC1 and FC2 are foreign corporations that are not PFICs. FC1 and FC2 each own 50% of the stock of FC3, a foreign corporation that is a PFIC.

(*2*) *Results*. Under paragraphs (b)(8)(iii)(A) and (b)(8)(iv) of this section, for purposes of determining whether B is a shareholder of FC3, B is considered to actually own 50% (50% × 100%) of the stock of FC1 and 25% (50% × 50%) of the stock of FC2. Under paragraphs (b)(8)(ii)(A) and (b)(8)(iv) of this section, B is then considered to own 25% (50% × 100% × 50%) of the stock of FC3 indirectly through FC1, and thus is a shareholder of FC3 for purposes of the PFIC provisions. Because B is considered to own less than 50% of FC2, B is not considered to own any stock of FC3 indirectly through FC2.

(C) *Example 3—(1) Facts*. The facts are the same as in paragraph (b)(8)(v)(B)(*1*) of this section (the facts in *Example 2*), except that B owns 40% of the interests in Foreign Partnership.

(*2*) *Results*. Under paragraph (b)(8)(iii)(A) and (b)(8)(iv) of this section, for purposes of determining whether B is a shareholder of FC3, B is considered to actually own 40% (40% × 100%) of the stock of FC1 and 20% (40% × 50%) of the stock of FC2, and thus is not considered to own 50% or more of the stock of FC1 or FC2. Under paragraphs (b)(8)(ii)(A) and (b)(8)(iv) of this section, B is not considered to own any stock of FC3 indirectly through FC1 or FC2.

(D) *Example 4—(1) Facts*. The facts are the same as in paragraph (b)(8)(v)(C)(*1*) of this section (the facts in *Example 3*), except that FP owns only 80% of FC1 and B also directly owns 20% of FC1.

(*2*) *Results*. Under paragraph (b)(8)(iii)(A) and (b)(8)(iv) of this section, for purposes of determining whether B is a shareholder of FC3, B is considered to own 32% (40% × 80%) of the stock of FC1 and 20% (40% × 50%) of the stock of FC2. Because B directly owns 20% of FC1, B is considered to actually own 52% (32% + 20%) of the stock of FC1 in total. Under paragraphs (b)(8)(ii)(A) and (b)(8)(iv) of this section, B is considered to own 26% (52% × 50%) of the stock of FC3 indirectly through FC1, and thus is a shareholder of FC3 for purposes of the PFIC provisions. B is not considered to own any stock of FC3 indirectly through FC2.

(c) *Coordination with other PFIC rules*.

(1)–(2) [Reserved]

(3) *Coordination with section 1296: distributions and dispositions*. If PFIC stock is marked to market under section 1296 for any taxable year, then, except as provided in § 1.1296–1(i), section 1291 and the regulations thereunder shall not apply to any distribution with respect to section 1296 stock (as defined in § 1.1296–1(a)(2)), or to any disposition of such stock, for such taxable year.

(4) *Coordination with mark to market rules under chapter 1 of the Internal Revenue Code other than section 1296*—(i) *In general*. If PFIC stock is marked to market for any taxable year under section 475 or any other provision of chapter 1 of the Internal Revenue Code, other than section 1296, regardless of whether the application of such provision is mandatory or results from an election by the taxpayer or another person, then, except as provided in paragraph (c)(4)(ii) of this section, section 1291 and the regulations thereunder shall not apply to any distribution with respect to such PFIC stock or to any disposition of such PFIC stock for such taxable year. *See* §§ 1.1295–1(i)(3) and 1.1296–1(h)(3)(i) for rules regarding the automatic termination of an existing election under section 1295 or section 1296 when a taxpayer marks to market PFIC stock under section 475 or any other provision of chapter 1 of the Internal Revenue Code.

(ii) *Coordination rule*—(A) Notwithstanding any provision in this section to the contrary, the rule of paragraph (c)(4)(ii)(B) of this section shall apply to the first taxable year in which a United States person marks to market its PFIC stock under a provision of chapter 1 of the Internal Revenue Code, other than section 1296, if such foreign corporation was a PFIC for any taxable year, prior to such first taxable year, during the United States person's holding period (as defined in section 1291(a)(3)(A) and § 1.1296–1(f)) in such stock, and for which such corporation

was not treated as a QEF with respect to such United States person.

(B) For the first taxable year of a United States person that marks to market its PFIC stock under any provision of chapter 1 of the Internal Revenue Code, other than section 1296, such United States person shall, in lieu of the rules under which the United States person marks to market, apply the rules of §1.1296–1(i)(2) and (3) as if the United States person had made an election under section 1296 for such first taxable year.

(d) [Reserved]

(e) *Exempt organization as shareholder*—(1) *In general.* If the shareholder of a PFIC is an organization exempt from tax under this chapter, section 1291 and these regulations apply to such shareholder only if a dividend from the PFIC would be taxable to the organization under subchapter F.

(2) *Ownership through certain tax-exempt organizations and accounts.* To the extent a United States person owns stock of a PFIC through an organization or account described in §1.1298–1(c)(1), that person is not treated as a shareholder with respect to the PFIC stock.

(f)–(i) [Reserved]

(j) *Applicability dates.* (1) Paragraphs (c)(3) and (4) of this section apply for taxable years beginning on or after May 3, 2004.

(2) Paragraph (e)(1) of this section is applicable on and after April 1, 1992.

(3) Except as otherwise provided in paragraph (j)(4) of this section, paragraphs (b)(2)(ii) and (v), (b)(7) and (8), and (e)(2) of this section apply to taxable years of shareholders ending on or after December 31, 2013.

(4) Paragraphs (b)(8)(iv) and (b)(8)(v)(A), (B), (C), and (D) of this section apply for taxable years of shareholders beginning on or after January 14, 2021. A shareholder may choose to apply such paragraphs for any open taxable year beginning before January 14, 2021, provided that, with respect to a tested foreign corporation, the shareholder consistently applies such paragraphs and the provisions of §§1.1297–1 (except that consistent treatment is not required with respect to §1.1297–1(c)(1)(i)(A)), 1.1297–2, 1.1297–4, 1.1297–6, 1.1298–2, and 1.1298–4 for such year and all subsequent years.

[T.D. 8750, 63 FR 13, Jan. 2, 1998. Redesignated by T.D. 8870, 65 FR 5779, Feb. 7, 2000, as amended by T.D. 9123, 69 FR 24073, May 3, 2004; T.D. 9806, 81 FR 95465, Dec. 28, 2016; T.D. 9936, 86 FR 4555, Jan. 15, 2021]

§ 1.1291–9 Deemed dividend election.

(a) *Deemed dividend election*—(1) *In general.* This section provides rules for making the election under section 1291(d)(2)(B) (deemed dividend election). Under that section, a shareholder (as defined in paragraph (j)(3) of this section) of a PFIC that is an unpedigreed QEF may elect to include in income as a dividend the shareholder's pro rata share of the post-1986 earnings and profits of the PFIC attributable to the stock held on the qualification date (as defined in paragraph (e) of this section), provided the PFIC is a controlled foreign corporation (CFC) within the meaning of section 957(a) for the taxable year for which the shareholder elects under section 1295 to treat the PFIC as a QEF (section 1295 election). If the shareholder makes the deemed dividend election, the PFIC will become a pedigreed QEF with respect to the shareholder. The deemed dividend is taxed under section 1291 as an excess distribution received on the qualification date. The excess distribution determined under this paragraph (a) is allocated under section 1291(a)(1)(A) only to those days in the shareholder's holding period during which the foreign corporation qualified as a PFIC. For purposes of the preceding sentence, the holding period of the PFIC stock with respect to which the election is made ends on the day before the qualification date. For the definitions of PFIC, QEF, unpedigreed QEF, and pedigreed QEF, see paragraph (j) (1) and (2) of this section.

(2) *Post-1986 earnings and profits defined*—(i) *In general.* For purposes of this section, the term post-1986 earnings and profits means the undistributed earnings and profits, within the meaning of section 902(c)(1), as of the day before the qualification date, that were accumulated and not distributed in taxable years of the PFIC beginning after 1986 and during which it was a PFIC, but without regard to whether

the earnings relate to a period during which the PFIC was a CFC.

(ii) *Pro rata share of post-1986 earnings and profits attributable to shareholder's stock*—(A) *In general*. A shareholder's pro rata share of the post-1986 earnings and profits of the PFIC attributable to the stock held by the shareholder on the qualification date is the amount of post-1986 earnings and profits of the PFIC accumulated during any portion of the shareholder's holding period ending at the close of the day before the qualification date and attributable, under the principles of section 1248 and the regulations under that section, to the PFIC stock held on the qualification date.

(B) *Reduction for previously taxed amounts*. A shareholder's pro rata share of the post-1986 earnings and profits of the PFIC does not include any amount that the shareholder demonstrates to the satisfaction of the Commissioner (in the manner provided in paragraph (d)(2) of this section) was, pursuant to another provision of the law, previously included in the income of the shareholder, or of another U.S. person if the shareholder's holding period of the PFIC stock includes the period during which the stock was held by that other U.S. person.

(b) *Who may make the election*. A shareholder of an unpedigreed QEF that is a CFC for the taxable year of the PFIC for which the shareholder makes the section 1295 election may make the deemed dividend election provided the shareholder held stock of that PFIC on the qualification date. A shareholder is treated as holding stock of the PFIC on the qualification date if its holding period with respect to that stock under section 1223 includes the qualification date. A shareholder may make the deemed dividend election without regard to whether the shareholder is a United States shareholder within the meaning of section 951(b). A deemed dividend election may be made by a shareholder whose pro rata share of the post-1986 earnings and profits of the PFIC attributable to the PFIC stock held on the qualification date is zero.

(c) *Time for making the election*. The shareholder makes the deemed dividend election in the shareholder's return for the taxable year that includes the qualification date. If the shareholder and the PFIC have the same taxable year, the shareholder makes the deemed dividend election in either the original return for the taxable year for which the shareholder makes the section 1295 election, or in an amended return for that year. If the shareholder and the PFIC have different taxable years, the deemed dividend election must be made in an amended return for the taxable year that includes the qualification date. If the deemed dividend election is made in an amended return, the amended return must be filed by a date that is within three years of the due date, as extended under section 6081, of the original return for the taxable year that includes the qualification date.

(d) *Manner of making the election*—(1) *In general*. A shareholder makes the deemed dividend election by filing Form 8621 and the attachment to Form 8621 described in paragraph (d)(2) of this section with the return for the taxable year of the shareholder that includes the qualification date, reporting the deemed dividend as an excess distribution pursuant to section 1291(a)(1), and paying the tax and interest due on the excess distribution. A shareholder that makes the deemed dividend election after the due date of the return (determined without regard to extensions) for the taxable year that includes the qualification date must pay additional interest, pursuant to section 6601, on the amount of the underpayment of tax for that year.

(2) *Attachment to Form 8621*. The shareholder must attach a schedule to Form 8621 that demonstrates the calculation of the shareholder's pro rata share of the post-1986 earnings and profits of the PFIC that is treated as distributed to the shareholder on the qualification date pursuant to this section. If the shareholder is claiming an exclusion from its pro rata share of the post-1986 earnings and profits for an amount previously included in its income or the income of another U.S. person, the shareholder must include the following information:

(i) The name, address, and taxpayer identification number of each U.S. person that previously included an

amount in income, the amount previously included in income by each such U.S. person, the provision of the law pursuant to which the amount was previously included in income, and the taxable year or years of inclusion of each amount; and

(ii) A description of the transaction pursuant to which the shareholder acquired, directly or indirectly, the stock of the PFIC from another U.S. person, and the provisions of law pursuant to which the shareholder's holding period includes the period the other U.S. person held the CFC stock.

(e) *Qualification date*—(1) *In general.* Except as otherwise provided in this paragraph (e), the qualification date is the first day of the PFIC's first taxable year as a QEF (first QEF year).

(2) *Elections made after March 31, 1995, and before January 27, 1997*—(i) *In general.* The qualification date for deemed dividend elections made after March 31, 1995, and before January 27, 1997, is the first day of the shareholder's election year. The shareholder's election year is the taxable year of the shareholder for which it made the section 1295 election.

(ii) *Exception.* A shareholder who made the deemed dividend election after May 1, 1992, and before January 27, 1997, may elect to change its qualification date to the first day of the first QEF year, provided the periods of limitations on assessment for the taxable year that includes that date and for the shareholder's election year have not expired. A shareholder changes the qualification date by filing amended returns, with revised Forms 8621 and the attachments described in paragraph (d)(2) of this section, for the shareholder's election year and the shareholder's taxable year that includes the first day of the first QEF year, and making all appropriate adjustments and payments.

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

Example 1. (i) *Eligibility to make deemed dividend election.* A is a U.S. person who files its income tax return on a calendar year basis. On January 2, 1994, A purchased one percent of the stock of M, a PFIC with a taxable year ending November 30. M was both a CFC and a PFIC, but not a QEF, for all of its taxable years. On December 3, 1996, M made a distribution to its shareholders. A received $100, all of which A reported in its 1996 return as an excess distribution as provided in section 1291(a)(1). A decides to make the section 1295 election in A's 1997 taxable year to treat M as a QEF effective for M's taxable year beginning December 1, 1996. Because A did not make the section 1295 election in 1994, the first year in its holding period of M stock that M qualified as a PFIC, M would be an unpedigreed QEF and A would be subject to both sections 1291 and 1293. A, however, may elect under section 1291(d)(2) to purge the years M was not a QEF from A's holding period. If A makes the section 1291(d)(2) election, the December 3 distribution will not be taxable under section 1291(a). Because M is a CFC, even though A is not a U.S. shareholder within the meaning of section 951(b), A may make the deemed dividend election under section 1291(d)(2)(B).

(ii) *Making the election.* Under paragraph (e)(1) of this section, the qualification date, and therefore the date of the deemed dividend, is December 1, 1996. Accordingly, to make the deemed dividend election, A must file an amended return for 1996, and include the deemed dividend in income in that year. As a result, M will be a pedigreed QEF as of December 1, 1996, and the December 3, 1996, distribution will not be taxable as an excess distribution. Therefore, in its amended return, A may report the December 3, 1996, distribution consistent with section 1293 and the general rules applicable to corporate distributions.

Example 2. X, a U.S. person, owned a five percent interest in the stock of FC, a PFIC with a taxable year ending June 30. X never made the section 1295 election with respect to FC. X transferred her interest in FC to her granddaughter, Y, a U.S. person, on February 14, 1996. The transfer qualified as a gift for Federal income tax purposes, and no gain was recognized on the transfer (see Regulation Project INTL–656–87, published in 1992–1 C.B. 1124; see § 601.601(d)(2)(ii)(*b*) of this chapter). As provided in section 1223(2), Y's holding period includes the period that X held the FC stock. Y decides to make the section 1295 election in her 1996 return to treat FC as a QEF for its taxable year beginning July 1, 1995. However, because Y's holding period includes the period that X held the FC stock, and FC was a PFIC but not a QEF during that period, FC will be an unpedigreed QEF with respect to Y unless Y makes a section 1291(d)(2) election. Although Y did not actually own the stock of FC on the qualification date (July 1, 1995), Y's holding period includes that date. Therefore, provided FC is a CFC for its taxable year beginning July 1, 1995, Y may make a section 1291(d)(2)(B) election to treat FC as a pedigreed QEF.

(f) *Adjustment to basis.* A shareholder that makes the deemed dividend election increases its adjusted basis of the

stock of the PFIC owned directly by the shareholder by the amount of the deemed dividend. If the shareholder makes the deemed dividend election with respect to a PFIC of which it is an indirect shareholder, the shareholder's adjusted basis of the stock or other property owned directly by the shareholder, through which ownership of the PFIC is attributed to the shareholder, is increased by the amount of the deemed dividend. In addition, solely for purposes of determining the subsequent treatment under the Code and regulations of a shareholder of the stock of the PFIC, the adjusted basis of the direct owner of the stock of the PFIC is increased by the amount of the deemed dividend.

(g) *Treatment of holding period.* For purposes of applying sections 1291 through 1297 to the shareholder after the deemed dividend, the shareholder's holding period of the stock of the PFIC begins on the qualification date. For other purposes of the Code and regulations, this holding period rule does not apply.

(h) *Coordination with section 959(e).* For purposes of section 959(e), the entire deemed dividend is treated as included in gross income under section 1248(a).

(i) *Election inapplicable to shareholder of a former PFIC or of a section 1297(e) PFIC.* A shareholder may not make the section 1295 and deemed dividend elections if the foreign corporation is a former PFIC (as defined in paragraph (j)(2)(iv) of this section) or a section 1297(e) PFIC (as defined in paragraph (j)(2)(v) of this section) with respect to the shareholder. For the rules regarding the election by a shareholder of a former PFIC, see §1.1298–3. For the rules regarding the election by a shareholder of a section 1297(e) PFIC, see §1.1297–3.

(j) *Definitions*—(1) *Passive foreign investment company (PFIC).* A passive foreign investment company (PFIC) is a foreign corporation that satisfies either the income test of section 1296(a)(1) or the asset test of section 1296(a)(2). A corporation will not be treated as a PFIC with respect to a shareholder for those days included in the shareholder's holding period when the shareholder, or a person whose holding period of the stock is included in the shareholder's holding period, was not a United States person within the meaning of section 7701(a)(30).

(2) *Types of PFICs*—(i) *Qualified electing fund (QEF).* A PFIC is a qualified electing fund (QEF) with respect to a shareholder that has elected, under section 1295, to be taxed currently on its share of the PFIC's earnings and profits pursuant to section 1293.

(ii) *Pedigreed QEF.* A PFIC is a pedigreed QEF with respect to a shareholder if the PFIC has been a QEF with respect to the shareholder for all taxable years during which the corporation was a PFIC that are included wholly or partly in the shareholder's holding period of the PFIC stock.

(iii) *Unpedigreed QEF.* A PFIC is an unpedigreed QEF for a taxable year if—

(A) An election under section 1295 is in effect for that year;

(B) The PFIC has been a QEF with respect to the shareholder for at least one, but not all, of the taxable years during which the corporation was a PFIC that are included wholly or partly in the shareholder's holding period of the PFIC stock; and

(C) The shareholder has not made an election under section 1291(d)(2) and this section or §1.1291–10 with respect to the PFIC to purge the nonQEF years from the shareholder's holding period.

(iv) *Former PFIC.* A foreign corporation is a former PFIC with respect to a shareholder if the corporation satisfies neither the income test of section 1297(a)(1) nor the asset test of section 1297(a)(2), but its stock, held by that shareholder, is treated as stock of a PFIC, pursuant to section 1298(b)(1), because the corporation was a PFIC that was not a QEF at some time during the shareholder's holding period of the stock.

(v) *Section 1297(e) PFIC.* A foreign corporation is a section 1297(e) PFIC with respect to a shareholder (as defined in paragraph (j)(3) of this section) if—

(A) The foreign corporation qualifies as a PFIC under section 1297(a) on the first day on which the qualified portion of the shareholder's holding period in the foreign corporation begins, as determined under section 1297(e)(2); and

(B) The stock of the foreign corporation held by the shareholder is treated

as stock of a PFIC, pursuant to section 1298(b)(1), because, at any time during the shareholder's holding period of the stock, other than the qualified portion, the corporation was a PFIC that was not a QEF.

(3) A shareholder is a United States person that is a shareholder as defined in § 1.1291–1(b)(7) or an indirect shareholder as defined in § 1.1291–1(b)(8), except as provided in § 1.1291–1(e).

(k) *Effective/applicability date.* (1) The rules of this section, except for paragraph (j)(2)(v) of this section, are applicable as of April 1, 1995.

(2) The rules of paragraph (j)(2)(v) of this section are applicable as of December 8, 2005.

(3) Paragraph (j)(3) of this section applies to taxable years of shareholders ending on or after December 31, 2013.

[T.D. 8701, 61 FR 68151, Dec. 27, 1996; 62 FR 7155, Feb. 18, 1997, as amended by T.D. 8750, 63 FR 13, Jan. 2, 1998; T.D. 9231, 70 FR 72915, Dec. 8, 2005; T.D. 9360, 72 FR 54821, Sept. 27, 2007; T.D. 9650, 78 FR 79608, Dec. 31, 2013; T.D. 9806, 81 FR 95466, Dec. 28, 2016]

§ 1.1291–10 Deemed sale election.

(a) *Deemed sale election.* This section provides rules for making the election under section 1291(d)(2)(A) (deemed sale election). Under that section, a shareholder (as defined in § 1.1291–9(j)(3)) of a PFIC that is an unpedigreed QEF may elect to recognize gain with respect to the stock of the unpedigreed QEF held on the qualification date (as defined in paragraph (e) of this section). If the shareholder makes the deemed sale election, the PFIC will become a pedigreed QEF with respect to the shareholder. A shareholder that makes the deemed sale election is treated as having sold, for its fair market value, the stock of the PFIC that the shareholder held on the qualification date. The gain recognized on the deemed sale is taxed under section 1291 as an excess distribution received on the qualification date. In the case of an election made by an indirect shareholder, the amount of gain to be recognized and taxed as an excess distribution is the amount of gain that the direct owner of the stock of the PFIC would have realized on an actual sale or other disposition of the stock of the PFIC indirectly owned by the shareholder. Any loss realized on the deemed sale is not recognized. For the definitions of PFIC, QEF, unpedigreed QEF, and pedigreed QEF, see § 1.1291–9(j) (1) and (2).

(b) *Who may make the election.* A shareholder of an unpedigreed QEF may make the deemed sale election provided the shareholder held stock of that PFIC on the qualification date. A shareholder is treated as holding stock of the PFIC on the qualification date if its holding period with respect to that stock under section 1223 includes the qualification date. A deemed sale election may be made by a shareholder that would realize a loss on the deemed sale.

(c) *Time for making the election.* The shareholder makes the deemed sale election in the shareholder's return for the taxable year that includes the qualification date. If the shareholder and the PFIC have the same taxable year, the shareholder makes the deemed sale election in either the original return for the taxable year for which the shareholder makes the section 1295 election, or in an amended return for that year. If the shareholder and the PFIC have different taxable years, the deemed sale election must be made in an amended return for the taxable year that includes the qualification date. If the deemed sale election is made in an amended return, the amended return must be filed by a date that is within three years of the due date, as extended under section 6081, of the original return for the taxable year that includes the qualification date.

(d) *Manner of making the election.* A shareholder makes the deemed sale election by filing Form 8621 with the return for the taxable year of the shareholder that includes the qualification date, reporting the gain as an excess distribution pursuant to section 1291(a), and paying the tax and interest due on the excess distribution. A shareholder that makes the deemed sale election after the due date of the return (determined without regard to extensions) for the taxable year that includes the qualification date must pay additional interest, pursuant to section 6601, on the amount of the underpayment of tax for that year. A shareholder that realizes a loss on the

deemed sale reports the loss on Form 8621, but does not recognize the loss.

(e) *Qualification date*—(1) *In general.* Except as otherwise provided in this paragraph (e), the qualification date is the first day of the PFIC's first taxable year as a QEF (first QEF year).

(2) *Elections made after March 31, 1995, and before January 27, 1997*—(i) *In general.* The qualification date for deemed sale elections made after March 31, 1995, and before January 27, 1997, is the first day of the shareholder's election year. The shareholder's election year is the taxable year of the shareholder for which it made the section 1295 election.

(ii) *Exception.* A shareholder who made the deemed sale election after May 1, 1992, and before January 27, 1997, may elect to change its qualification date to the first day of the first QEF year, provided the periods of limitations on assessment for the taxable year that includes that date and for the shareholder's election year have not expired. A shareholder changes the qualification date by filing amended returns, with revised Forms 8621, for the shareholder's election year and the shareholder's taxable year that includes the first day of the first QEF year, and making all appropriate adjustments and payments.

(f) *Adjustments to basis*—(1) *In general.* A shareholder that makes the deemed sale election increases its adjusted basis of the PFIC stock owned directly by the amount of gain recognized on the deemed sale. If the shareholder makes the deemed sale election with respect to a PFIC of which it is an indirect shareholder, the shareholder's adjusted basis of the stock or other property owned directly by the shareholder, through which ownership of the PFIC is attributed to the shareholder, is increased by the amount of gain recognized by the shareholder. In addition, solely for purposes of determining the subsequent treatment under the Code and regulations of a shareholder of the stock of the PFIC, the adjusted basis of the direct owner of the stock of the PFIC is increased by the amount of gain recognized on the deemed sale. A shareholder shall not adjust the basis of any stock with respect to which the shareholder realized a loss on the deemed sale.

(2) *Adjustment of basis for section 1293 inclusion with respect to deemed sale election made after March 31, 1995, and before January 27, 1997.* For purposes of determining the amount of gain recognized with respect to a deemed sale election made after March 31, 1995, and before January 27, 1997, by a shareholder that treats the first day of the shareholder's election year as the qualification date, the adjusted basis of the stock deemed sold includes the shareholder's section 1293(a) inclusion attributable to the period beginning with the first day of the PFIC's first QEF year and ending on the day before the qualification date.

(g) *Treatment of holding period.* For purposes of applying sections 1291 through 1297 to the shareholder after the deemed sale, the shareholder's holding period of the stock of the PFIC begins on the qualification date, without regard to whether the shareholder recognized gain on the deemed sale. For other purposes of the Code and regulations, this holding period rule does not apply.

(h) *Election inapplicable to shareholder of former PFIC.* A shareholder may not make the section 1295 and deemed sale elections if the foreign corporation is a former PFIC (as defined in § 1.1291–9(j)(2)(iv)) with respect to the shareholder. For the rules regarding the election by a shareholder of a former PFIC, see § 1.1297–3T.

(i) *Effective date.* The rules of this section are applicable as of April 1, 1995.

[T.D. 8701, 61 FR 68153, Dec. 27, 1996]

§ 1.1293–0 Table of contents.

This section contains a listing of the headings for § 1.1293–1.

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(1) In general.
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(ii) Pass through entity does not make a section 1295 election.

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[T.D. 8750, 63 FR 13, Jan. 2, 1998, as amended by T.D. 8870, 65 FR 16319, Mar. 28, 2000]

§ 1.1293–1 Current taxation of income from qualified electing funds.

(a) *In general.* [Reserved]

(1) *Other rules.* [Reserved]

(2) *Net capital gain defined*—(i) *In general.* This paragraph (a)(2) defines the term net capital gain for purposes of sections 1293 and 1295 and the regulations under those sections. The QEF, as defined in §1.1291–9(j)(2)(i), in determining its net capital gain for a taxable year, may either—

(A) Calculate and report the amount of each category of long-term capital gain provided in section 1(h) that was recognized by the PFIC in the taxable year;

(B) Calculate and report the amount of net capital gain recognized by the PFIC in the taxable year, stating that that amount is subject to the highest capital gain rate of tax applicable to the shareholder; or

(C) Calculate its earnings and profits for the taxable year and report the entire amount as ordinary earnings.

(ii) *Effective date.* Paragraph (a)(2)(i) of this section is applicable to sales by QEFs during their taxable years ending on or after May 7, 1997.

(b) *Other rules.* [Reserved]

(c) *Application of rules of inclusion with respect to stock held by a pass through entity*—(1) *In general.* If a domestic pass through entity makes a section 1295 election, as provided in paragraph (d)(2) of this section, with respect to the PFIC shares that it owns, directly or indirectly, the domestic pass through entity takes into account its pro rata share of the ordinary earnings and net capital gain attributable to the QEF shares held by the pass through entity. A U.S. person that indirectly owns QEF shares through the domestic pass through entity accounts for its pro rata shares of ordinary earnings and net capital gain attributable to the QEF shares according to the general rules applicable to inclusions of income from the domestic pass through entity. For the definition of pass through entity, see §1.1295–1(j).

(2) *QEF stock transferred to a pass through entity*—(i) *Pass through entity makes a section 1295 election.* If a shareholder transfers stock subject to a section 1295 election to a domestic pass through entity of which it is an interest holder and the pass through entity makes a section 1295 election with respect to that stock, as provided in §1.1295–1(d)(2), the shareholder takes into account its pro rata shares of the ordinary earnings and net capital gain attributable to the QEF shares under the rules applicable to inclusions of income from the pass through entity.

(ii) *Pass through entity does not make a section 1295 election.* If the pass through entity does not make a section 1295 election with respect to the PFIC, the shares of which were transferred to the pass through entity subject to the 1295 election of the shareholder, the shareholder continues to be subject, in its capacity as an indirect shareholder, to the income inclusion rules of section 1293 and reporting rules required of shareholders of QEFs. Proper adjustments to reflect an inclusion in income under section 1293 by the indirect shareholder must be made, under the principles of §1.1291–9(f), to the basis of the indirect shareholder's interest in the pass through entity.

(3) *Effective date.* Paragraph (c) of this section is applicable to taxable years of shareholders beginning after December 31, 1997.

[T.D. 8750, 63 FR 14, Jan. 2, 1998. Redesignated and amended by T.D. 8870, 65 FR 5779, 5781, Feb. 7, 2000]

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This section contains a listing of the headings for §1.1294–1T.

§ 1.1294–1T Election to extend the time for payment of tax on undistributed earnings of a qualified electing fund.

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(b) Election to extend time for payment of tax.

(1) In general.

(2) Exception.

(3) Undistributed earnings.

(i) In general.

(ii) Effect of loan, pledge or guarantee.

(c) Time for making the election.

(1) In general.

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(d) Manner of making the election.

(1) In general.

(2) Information to be included in the election.

(e) Termination of the extension.

(f) Undistributed PFIC earnings tax liability.

(g) Authority to require a bond.

(h) Annual reporting requirement.

[T.D. 8750, 63 FR 13, Jan. 2, 1998]

§ 1.1294–1T Election to extend the time for payment of tax on undistributed earnings of a qualified electing fund (temporary).

(a) *Purpose and scope.* This section provides rules for making the annual election under section 1294. Under that section, a U.S. person that is a shareholder in a qualified electing fund (QEF) may elect to extend the time for payment of its tax liability which is attributable to its share of the undistributed earnings of the QEF. In general, a QEF is a passive foreign investment company (PFIC), as defined in section 1296, that makes the election under section 1295. Under section 1293, a U.S. person that owns, or is treated as owning, stock of a QEF at any time during the taxable year of the QEF shall include in gross income, as ordinary income, its pro rata share of the ordinary earnings of the QEF for the taxable year and, as long-term capital gain, its pro rata share of the net capital gain of the QEF for the taxable year. The shareholder's share of the earnings shall be included in the shareholder's taxable year in which or with which the taxable year of the QEF ends.

(b) *Election to extend time for payment*—(1) *In general.* A U.S. person that is a shareholder of a QEF on the last day of the QEF's taxable year may elect under section 1294 to extend the time for payment of that portion of its tax liability which is attributable to the inclusion in income pursuant to section 1293 of the shareholder's share of the QEF's undistributed earnings. The election under section 1294 may be made only with respect to undistributed earnings, and interest is imposed under section 6601 on the amount of the tax liability which is subject to the extension. This interest must be paid on the termination of the election.

(2) *Exception.* An election under this § 1.1294–1T cannot be made for a taxable year of the shareholder if any portion of the QEF's earning is includible in the gross income of the shareholder for such year under either section 551 (relating to foreign personal holding companies) or section 951 (relating to controlled foreign corporations).

(3) *Undistributed earnings*—(i) *In general.* For purposes of this § 1.1294–1T the term *undistributed earnings* means the excess, if any, of the amount includible in gross income by reason of section 1293(a) for the shareholder's taxable year (the includible amount) over the sum of (A) the amount of any distribution to the shareholder during the QEF's taxable year and (B) the portion of the includible amount that is attributable to stock in the QEF that the shareholder transferred or otherwise disposed of before the end of the QEF's year. For purposes of this paragraph, a distribution will be treated as made from the most recently accumulated earnings and profits.

(ii) *Effect of a loan, pledge or guarantee.* A loan, pledge, or guarantee described in § 1.1294–1T(e) (2) or (4) will be treated as a distribution of earnings for purposes of paragraph (b)(3)(i)(A). If earnings are treated as distributed in a taxable year by reason of a loan, pledge or guarantee described in § 1.1294–1T(e) (2) or (4), but the amount of the deemed distribution resulting therefrom was less than the amount of the actual loan by the QEF (or the amount of the loan secured by the pledge or guarantee), earnings derived by the QEF in a subsequent taxable year will be treated as distributed in such subsequent year to the shareholder for purposes of paragraph (b)(3)(i)(A) by virtue of such loan, but only to the extent of the difference between the outstanding principal balance on the loan in such subsequent year and the prior years' deemed distributions resulting from the loan. For this purpose, the outstanding principal balance on a loan in a taxable year shall be treated as equal to the greatest amount of the outstanding balance at any time during such year.

Example 1. (i) *Facts. FC* is a PFIC that made the election under section 1295 to be a QEF for its taxable year beginning January 1, 1987. *S* owned 500 shares, or 50 percent, of *FC* throughout the first six months of 1987, but on June 30, 1987 sold 10 percent, or 50 shares, of the *FC* stock that it held. *FC* had $100,000*x* of ordinary earnings but no net capital gain in 1987. No part of *FC*'s earnings is includible

in *S*'s income under either section 551 or 951. *FC* made no distributions to its shareholders in 1987. *S's* pro rata share of income is determined by attributing *FC's* income ratably to each day in *FC*'s year. Accordingly, FC's daily earnings are $274*x* ($100,000*x*/365). *S*'s share of the earnings of *FC* is $47,484*x*, determined as follows.

FC's daily earnings × number of days percentage held by *S* × percentage of ownership in *FC*.

Accordingly, *S*'s pro rata share of *FC*'s earnings for the first six months of *FC*'s year deemed earned while *S* held 50 percent of *FC*'s stock is $24,797*x* ($274*x* × 181 days × 50%). *S*'s pro rata share of *FC*'s earnings for remainder of *FC*'s year deemed earned while *S* held 45 percent of *FC*'s stock is $22,687*x* ($274*x* × 184 days × 45%). Therefore, *S*'s total share of *FC*'s earnings to be included in income under section 1293 is $47,484*x* ($24,797*x* + $22,687*x*).

(ii) *Election*. *S* intends to make the election under section 1294 to defer the payment of its tax liability that is attributable to the undistributed earnings of *FC*. The amount of current year undistributed earnings as defined in §1.1294–1T(b)(3) with respect to which *S* can make the election is the excess of *S*'s inclusion in gross income under section 1293(a) for the taxable year over the sum of (1) the cash and other property distributed to *S* during *FC*'s tax year out of earnings included in income pursuant to section 1293(a), and (2) the earnings attributable to stock disposed of during *FC*'s tax year. Because *S* sold 10 percent, or 50 shares, of the *FC* stock that it held during the first six months of the year, 10 percent of its share of the earnings for that part of the year, which is $2,480*x* ($24,797*x* × 10%), is attributable to the shares sold. *S* therefore cannot make the election under section 1294 to extend the time for payment of its tax liability on that amount. Accordingly, *S* can make the election under section 1294 with respect to its tax on $45,004*x* ($47,484*x* less $2,480*x*), which is its pro rata share of *FC*'s earnings, reduced by the earnings attributable to the stock disposed of during the year.

Example 2. (i) *Facts*. The facts are the same as in Example 1 with the following exceptions. *S* did not sell any *FC* stock during 1987. Therefore, because *S* held 50 percent of the *FC* stock throughout 1987, *S*'s pro rata share of *FC*'s ordinary earnings was $50,000*x*, no part of which was includible in *S*'s income under either section 551 or 951. There were no actual distributions of earnings to *S* in 1988. On December 31, 1987, *S* pledged the FC stock as security for a bank loan of $75,000*x*. The pledge is treated as a disposition of the *FC* stock and therefore a distribution of *S*'s share of the undistributed earnings of *FC* up to the amount of the loan principal. *S*'s entire share of the undistributed earnings of *FC* are deemed distributed as a result of the pledge of the *FC* stock. *S* therefore cannot make the election under section 1294 to extend the time for payment of its tax liability on its share of *FC*'s earnings for 1987.

(ii) *Deemed distribution*. In 1988, *FC* has ordinary earnings of $100,000*x* but no net capital gain. *S*'s pro rata share of *FC*'s 1988 ordinary earnings was $50,000*x*. *S*'s loan remained outstanding throughout 1988; the highest loan balance during 1988 was $74,000*x*. Of *S*'s share of the ordinary earnings of FC of $50,000*x*, $24,000*x* is deemed distributed to *S*. This is the amount by which the highest loan balance for the year ($74,000*x*) exceeds the portion of the undistributed earnings of *FC* deemed distributed to *S* in 1987 by reason of the pledge ($50,000*x*). *S* may make the election under section 1294 to extend the time for payment of its tax liability on $26,000*x*, which is the amount by which *S*'s includible amount for 1988 exceeds the amount deemed distributed to *S* during 1988.

(c) *Time for making the election*—(1) *In general*. An election under this §1.1294–1T may be made for any taxable year in which a shareholder reports income pursuant to section 1293. Except as provided in paragraph (c)(2), the election shall be made by the due date, as extended, of the tax return for the shareholder's taxable year for which the election is made.

(2) *Exception*. An election under this section may be made within 60 days of receipt of notification from the QEF of the shareholder's pro rata share of the ordinary earnings and net capital gain if notification is received after the time for filing the election provided in paragraph (c)(1) (and requires the filing of an amended return to report income pursuant to section 1293). If the notification reports an increase in the shareholder's pro rata share of the earnings previously reported to the shareholder by the QEF, the shareholder may make the election under this paragraph (c)(2) only with respect to the amount of such increase.

(d) *Manner of making the election*—(1) *In general*. A shareholder shall make the election by (i) attaching to its return for the year of the election Form 8621 or a statement containing the information and representations required by this section and (ii) filing a copy of Form 8621 or the statement with the Internal Revenue Service Center, P.O. Box 21086, Philadelphia, Pennsylvania 19114.

(2) *Information to be included in the election statement*. If a statement is used in lieu of Form 8621, the statement should be identified, in a heading, as an election under section 1294 of the Code. The statement must include the following information and representations:

(i) The name, address, and taxpayer identification number of the electing shareholder and the taxable year of the shareholder for which the election is being made;

(ii) The name, address and taxpayer identification number of the QEF if provided to the shareholder;

(iii) A statement that the shareholder is making the election under section 1294 of the Code;

(iv) A schedule containing the following information:

(A) The ordinary earnings and net capital gain for the current year included in the shareholder's income under section 1293;

(B) The amount of cash and other property distributed by the QEF during its taxable year with respect to stock held directly or indirectly by the shareholder during that year, identifying the amount of such distributions that is paid out of current earnings and profits and the amount paid out of each prior year's earnings and profits; and

(C) The undistributed PFIC earnings tax liability (as defined in paragraph (f) of this section) for the taxable year, payment of which is being deferred by reason of the election under section 1294;

(v) The number of shares of stock held in the QEF during the QEF's taxable year which gave rise to the section 1293 inclusion and the number of such shares transferred, deemed transferred or otherwise disposed of by the electing shareholder before the end of the QEF's taxable year, and the data of transfer; and

(vi) The representations of the electing shareholder that—

(A) No part of the QEF's earnings for the taxable year is includible in the electing shareholder's gross income under either section 551 or 951 of the Code;

(B) The election is made only with respect to the shareholder's pro rata share of the undistributed earnings of the QEF; and

(C) The electing shareholder, upon termination of the election to extend the date for payment, shall pay the undistributed PFIC earnings tax liability attributable to those earnings to which the termination applies as well as interest on such tax liability pursuant to section 6601. Payment of this tax and interest must be made by the due date (determined without extensions) of the tax return for the taxable year in which the termination occurs.

(e) *Termination of the extension*. The election to extend the date for payment of tax will be terminated in whole or in part upon the occurrence of any of the following events:

(1) The QEF's distribution of earnings to which the section 1294 extension to pay tax is attributable; the extension will terminate only with respect to the tax attributable to the earnings that were distributed.

(2) The electing shareholder's transfer of stock in the QEF (or use thereof as security for a loan) with respect to which an election under this §1.1294–1T was made. The election will be terminated with respect to the undistributed earnings attributable to the shares of the stock transferred. In the case of a pledge of the stock, the election will be terminated with respect to undistributed earnings equal to the amount of the loan for which the stock is pledged.

(3) Revocation of the QEF's election as a QEF or cessation of the QEF's status as a PFIC. A revocation of the QEF election or cessation of PFIC status will result in the complete termination of the extension.

(4) A loan of property by the QEF directly or indirectly to the electing shareholder or related person, or a pledge or guarantee by the QEF with respect to a loan made by another party to the electing shareholder or related person. The election will be terminated with respect to undistributed earnings in an amount equal to the amount of the loan, pledge, or guarantee.

(5) A determination by the District Director pursuant to section 1294(c)(3) that collection of the tax is in jeopardy. The amount of undistributed

earnings with respect to which the extension is terminated under this paragraph (d)(5) will be left to the discretion of the District Director.

(f) *Undistributed PFIC earnings tax liability*. The electing shareholder's tax liability attributable to the ordinary earnings and net capital gain included in gross income under section 1293 shall be the excess of the tax imposed under chapter 1 of the Code for the taxable year over the tax that would be imposed for the taxable year without regard to the inclusion in income under section 1293 of the undistributed earnings as defined in paragraph (b)(3) of this section.

Example: The facts are the same as in §1.1294–1T (b)(3), *Example 1*, with the following exceptions. *S*, a domestic corporation, did not dispose of any *FC* stock in 1987. Therefore, because *S* held 50 percent of the *FC* stock throughout 1987, *S*'s pro rata share of *FC*'s ordinary earnings was $50,000*x*. In addition to $50,000*x* of ordinary earnings from *FC*, *S* had $12,500*x* of domestic source income and $6,000*x* of expenses (other than interest expense) not definitely related to any gross income. These expenses are apportioned, pursuant to §1.861–8(c)(2), on a pro rata basis between the domestic and foreign source income—$1,200*x* of expenses, or one-fifth, to domestic source income, and $4,800*x* of expenses, or four-fifths, to the section 1293 inclusion. *FC* paid foreign taxes of $25,000*x* in 1987. Accordingly, *S* is entitled to claim as an indirect foreign tax credit pursuant to section 1293(f) a proportionate amount of the foreign taxes paid by *FC*, which is $12,500*x* ($25,000*x* × $50,000*x*/$100,000*x*). *S* is taxed in the U.S. at the rate of 34 percent. The amount of tax liability for which *S* may extend the time for payment is determined as follows:

1987 TAX LIABILITY (WITH SECTION 1293 INCLUSION)

Source	U.S.	Foreign
Income	12,500*x*	0
Section 1293	0	50,000*x*
Expenses	−1,200*x*	−4,800*x*
Taxable income	11,300*x*	45,200*x*
Total taxable income	56,500*x*	
U.S. income tax rate	x34%	
Pre-credit U.S. tax	19,210*x*	
Foreign tax credit	−12,500*x*	
1987 Tax Liability	6,710*x*	

1987 TAX LIABILITY (WITHOUT SECTION 1293 INCLUSION)

Source	U.S.	Foreign
Income	12,500*x*	0
Expenses	−6,000*x*	
Taxable income	6,500*x*	
U.S. tax rate	x34%	
U.S. Tax	2,210*x*	
Foreign tax credit	0	
Hypothetical 1987 Tax Liability	2,210*x*	

The amount of tax, payment of which *S* may defer pursuant to section 1294, is $4,500*x* ($6,710*x* less $2,210*x*).

(g) *Authority to require a bond*. Pursuant to the authority granted in section 6165 and in the manner provided therein, and subject to notification, the District Director may require the electing shareholder to furnish a bond to secure payment of the tax, the time for payment of which is extended under this section. If the electing shareholder does not furnish the bond within 60 days after receiving a request from the District Director, the election will be revoked.

(h) *Annual reporting requirement*. The electing shareholder must attach Form 8621 or a statement to its income tax return for each year during which an election under this section is outstanding. The statement must contain the following information:

(1) The total amount of undistributed earnings as of the end of the taxable year to which the outstanding elections apply;

(2) The total amount of the undistributed PFIC earnings tax liability and accrued interest charge as of the end of the year;

(3) The total amount of distributions received during the taxable year; and

(4) A description of the occurrence of any other termination event described in paragraph (e) of this section that occurred during the taxable year.

The electing shareholder also shall file by the due date, as extended, for its return a copy of Form 8621 or the statement with the Philadelphia Service Center, P.O. Box 21086, Philadelphia, Pennsylvania 19114.

[T.D. 8178, 53 FR 6773, Mar. 2, 1988; 53 FR 11731, Apr. 8, 1988]

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This section contains a listing of the headings for §§ 1.1295–1 and 1.1295–3.

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[T.D. 8750, 63 FR 14, Jan. 2, 1998, as amended by T.D. 8870, 65 FR 5779, Feb. 7, 2000; 65 FR 16319, Mar. 28, 2000; T.D. 9123, 69 FR 24073, May 3, 2004]

§ 1.1295–1 Qualified electing funds.

(a) *In general.* [Reserved]

(b) *Application of section 1295 election.* [Reserved]

(1) *Election personal to shareholder.* [Reserved]

(2) *Election applicable to specific corporation only*—

(i) *In general.* [Reserved]

(ii) *Stock of QEF received in a nonrecognition transfer.* [Reserved]

(iii) *Exception for options.* A shareholder's section 1295 election does not apply to any option to buy stock of the PFIC.

(3) *Application of general rules to stock held by a pass through entity*—(i) *Stock subject to a section 1295 election transferred to a pass through entity.* A shareholder's section 1295 election will not apply to a domestic pass through entity to which the shareholder transfers stock subject to section 1295 election, or to any other U.S. person that is an interest holder or beneficiary of the domestic pass through entity. However, as provided in paragraph (c)(2)(iv) of this section (relating to a transfer to a domestic pass through entity of stock subject to a section 1295 election), a shareholder that transfers stock subject to a section 1295 election to a pass through entity will continue to be subject to the section 1295 election with respect to the stock indirectly owned through the pass through entity and any other stock of that PFIC owned by the shareholder.

(ii) *Limitation on application of pass through entity's section 1295 election.* Except as provided in paragraph (c)(2)(iv) of this section, a section 1295 election made by a domestic pass through entity does not apply to other stock of the PFIC held directly or indirectly by the interest holder or beneficiary.

(iii) *Effect of partnership termination on section 1295 election.* Termination of a section 1295 election made by a domestic partnership by reason of the termination of the partnership under section 708(b) will not terminate the section 1295 election with respect to

partners of the terminated partnership that are partners of the new partnership. Except as otherwise provided, the stock of the PFIC of which the new partners are indirect shareholders will be treated as stock of a QEF only if the new domestic partnership makes a section 1295 election with respect to that stock.

(iv) *Characterization of stock held through a pass through entity.* Stock of a PFIC held through a pass through entity will be treated as stock of a pedigreed QEF with respect to an interest holder or beneficiary only if—

(A) In the case of PFIC stock acquired (other than in a transaction in which gain is not recognized pursuant to regulations under section 1291(f) with respect to that stock) and held by a domestic pass through entity, the pass through entity makes the section 1295 election and the PFIC has been a QEF with respect to the pass through entity for all taxable years that are included wholly or partly in the pass through entity's holding period of the PFIC stock and during which the foreign corporation was a PFIC within the meaning of §1.1291–9(j)(1); or

(B) In the case of PFIC stock transferred by an interest holder or beneficiary to a pass through entity in a transaction in which gain is not fully recognized (including pursuant to regulations under section 1291(f)), the pass through entity makes the section 1295 election with respect to the PFIC stock transferred for the taxable year in which the transfer was made. The PFIC stock transferred will be treated as stock of a pedigreed QEF by the pass through entity, however, only if that stock was treated as stock of a pedigreed QEF with respect to the interest holder or beneficiary at the time of the transfer, and the PFIC has been a QEF with respect to the pass through entity for all taxable years of the PFIC that are included wholly or partly in the pass through entity's holding period of the PFIC stock during which the foreign corporation was a PFIC within the meaning of §1.1291–9(j).

(v) *Characterization of stock distributed by a partnership.* In the case of PFIC stock distributed by a partnership to a partner in a transaction in which gain is not fully recognized, the PFIC stock will be treated as stock of a pedigreed QEF by the partners only if that stock was treated as stock of a pedigreed QEF with respect to the partnership for all taxable years of the PFIC that are included wholly or partly in the partnership's holding period of the PFIC stock during which the foreign corporation was a PFIC within the meaning of §1.1291–9(j), and the partner has a section 1295 election in effect with respect to the distributed PFIC stock for the partner's taxable year in which the distribution was made. If the partner does not have a section 1295 election in effect, the stock shall be treated as stock in a section 1291 fund. See paragraph (k) of this section for special applicability date of paragraph (b)(3)(v) of this section.

(4) *Application of general rules to a taxpayer filing a joint return under section 6013.* A section 1295 election made by a taxpayer in a joint return, within the meaning of section 6013, will be treated as also made by the spouse that joins in the filing of that return. See paragraph (k) of this section for special applicability date of paragraph (b)(4) of this section.

(c) *Effect of section 1295 election*—(1) *In general.* Except as otherwise provided in this paragraph (c), the effect of a shareholder's section 1295 election is to treat the foreign corporation as a QEF with respect to the shareholder for each taxable year of the foreign corporation ending with or within a taxable year of the shareholder for which the election is effective. A section 1295 election is effective for the shareholder's election year and all subsequent taxable years of the shareholder unless invalidated, terminated or revoked as provided in paragraph (i) of this section. The terms shareholder and shareholder's election year are defined in paragraph (j) of this section.

(2) *Years to which section 1295 election applies*—(i) *In general.* Except as otherwise provided in this paragraph (c), a foreign corporation with respect to which a section 1295 election is made will be treated as a QEF for its taxable year ending with or within the shareholder's election year and all subsequent taxable years of the foreign corporation that are included wholly or

partly in the shareholder's holding period (or periods) of stock of the foreign corporation.

(ii) *Effect of PFIC status on election.* A foreign corporation will not be treated as a QEF for any taxable year of the foreign corporation that the foreign corporation is not a PFIC under section 1297(a) and is not treated as a PFIC under section 1298(b)(1). Therefore, a shareholder shall not be required to include pursuant to section 1293 the shareholder's pro rata share of ordinary earnings and net capital gain for such year and shall not be required to satisfy the section 1295 annual reporting requirement of paragraph (f)(2) of this section for such year. Cessation of a foreign corporation's status as a PFIC will not, however, terminate a section 1295 election. Thus, if the foreign corporation is a PFIC in any taxable year after a year in which it is not treated as a PFIC, the shareholder's original election under section 1295 continues to apply and the shareholder must take into account its pro rata share of ordinary earnings and net capital gain for such year and comply with the section 1295 annual reporting requirement.

(iii) *Effect on election of complete termination of a shareholder's interest in the PFIC.* Complete termination of a shareholder's direct and indirect interest in stock of a foreign corporation will not terminate a shareholder's section 1295 election with respect to the foreign corporation. Therefore, if a shareholder reacquires a direct or indirect interest in any stock of the foreign corporation, that stock is considered to be stock for which an election under section 1295 has been made and the shareholder is subject to the income inclusion and reporting rules required of a shareholder of a QEF.

(iv) *Effect on section 1295 election of transfer of stock to a domestic pass through entity.* The transfer of a shareholder's direct or indirect interest in stock of a foreign corporation to a domestic pass through entity (as defined in paragraph (j) of this section) will not terminate the shareholder's section 1295 election with respect to the foreign corporation, whether or not the pass through entity makes a section 1295 election. For the rules concerning the application of section 1293 to stock transferred to a domestic pass through entity, see § 1.1293–1(c).

(v) *Examples.* The following examples illustrate the rules of this paragraph (c)(2).

Example 1. In 1998, C, a U.S. person, purchased stock of FC, a foreign corporation that is a PFIC. Both FC and C are calendar year taxpayers. C made a timely section 1295 election to treat FC as a QEF in C's 1998 return, and FC was therefore a pedigreed QEF. C included its shares of FC's 1998 ordinary earnings and net capital gain in C's 1998 Income and did not make a section 1294 election to defer the time for payment of tax on that income. In 1999, 2000, and 2001, FC did not satisfy either the income or asset test of section 1296(a), and therefore was neither a PFIC nor a QEF. C therefore did not have to include its pro rata shares of the ordinary earnings and net capital gain of FC pursuant to section 1293, or satisfy the section 1295 annual reporting requirements for any of those years. FC qualified as a PFIC again in 2002. Because C had made a section 1295 election in 1998, and the election had not been invalidated, terminated, or revoked, within the meaning of paragraph (i) of this section, C's section 1295 election remains in effect for 2002. C therefore is subject in 2002 to the income inclusion and reporting rules required of shareholders of QEFs.

Example 2. The facts are the same as in Example (1) except that FC did not lose PFIC status in any year and C sold all the FC stock in 1999 and repurchased stock of FC in 2002. Because C had made a section 1295 election in 1998 with respect to stock of FC, and the election had not been invalidated, terminated, or revoked, within the meaning of paragraph (i) of this section, C's section 1295 election remained in effect and therefore applies to the stock of FC purchased by C in 2002. C therefore is subject in 2002 to the income inclusion and reporting rules required of shareholders of QEFs.

Example 3. The facts are the same as in Example (2) except that C is a partner in domestic partnership P and C transferred its FC stock to P in 1999. Because C had made a section 1295 election in 1998 with respect to stock of FC, and the election had not been invalidated, terminated, or revoked, within the meaning of paragraph (i) of this section, C's section 1295 election remains in effect with respect to its indirect interest in the stock of FC. If P does not make the section 1295 election with respect to the FC stock, C will continue to be subject, in C's capacity as an indirect shareholder of FC, to the income inclusion and reporting rules required of shareholders of QEFs in 1999 and subsequent years for that portion of the FC stock C is treated as owning indirectly through the

partnership. If P makes the section 1295 election, C will take into account its pro rata shares of the ordinary earnings and net capital gain of the FC under the rules applicable to inclusions of income from P.

(d) *Who may make a section 1295 election*—(1) *General rule.* Except as otherwise provided in this paragraph (d), any U.S. person that is a shareholder (as defined in paragraph (j) of this section) of a PFIC, including a shareholder that holds stock of a PFIC in bearer form, may make a section 1295 election with respect to that PFIC. The shareholder need not own directly or indirectly any stock of the PFIC at the time the shareholder makes the section 1295 election provided the shareholder is a shareholder of the PFIC during the taxable year of the PFIC that ends with or within the taxable year of the shareholder for which the section 1295 election is made. Except in the case of a shareholder that is an exempt organization that may not make a section 1295 election, as provided in paragraph (d)(6) of this section, in a chain of ownership only the first U.S. person that is a shareholder of the PFIC may make the section 1295 election.

(2) *Application of general rule to pass through entities*—(i) *Partnerships*—(A) *Domestic partnership.* A domestic partnership that holds an interest in stock of a PFIC makes the section 1295 election with request to that PFIC. The partnership election applies only to the stock of the PFIC held directly or indirectly by the partnership and not to any other stock held directly or indirectly by any partner. As provided in §1.1293–1(c)(1), shareholders owning stock of a QEF by reason of an interest in the partnership take into account the section 1293 inclusions with respect to the QEF shares owned by the partnership under the rules applicable to inclusions of income from the partnership.

(B) *Foreign partnership.* A U.S. person that holds an interest in a foreign partnership that, in turn, holds an interest in stock of a PFIC makes the section 1295 election with respect to that PFIC. A partner's election applies to the stock of the PFIC owned directly or indirectly by the foreign partnership and to any other stock of the PFIC owned by that partner. A section 1295 election by a partner applies only to that partner.

(ii) *S corporation.* An S corporation that holds an interest in stock of a PFIC makes the section 1295 election with respect to that PFIC. The S corporation election applies only to the stock of the PFIC held directly or indirectly by the S corporation and not to any other stock held directly or indirectly by any S corporation shareholder. As provided in §1.1293–1(c)(1), shareholders owning stock of a QEF by reason of an interest in the S corporation take into account the section 1293 inclusions with respect to the QEF shares under the rules applicable to inclusions of income from the S corporation.

(iii) *Trust or estate*—(A) *Domestic trust or estate*—(*1*) *Nongrantor trust or estate.* A domestic nongrantor trust or a domestic estate that holds an interest in stock of a PFIC makes the section 1295 election with respect to that PFIC. The trust or estate's election applies only to the stock of the PFIC held directly or indirectly by the trust or estate and not to any other stock held directly or indirectly by any beneficiary. As provided in §1.1293–1(c)(1), shareholders owning stock of a QEF by reason of an interest in a domestic trust or estate take into account the section 1293 inclusions with respect to the QEF shares under the rules applicable to inclusions of income from the trust or estate.

(*2*) *Grantor trust.* A U.S. person that is treated under sections 671 through 678 as the owner of the portion of a domestic trust that owns an interest in stock of a PFIC makes the section 1295 election with respect to that PFIC. If that person ceases to be treated as the owner of the portion of the trust that owns an interest in the PFIC stock and is a beneficiary of the trust, that person's section 1295 election will continue to apply to the PFIC stock indirectly owned by that person under the rules of paragraph (c)(2)(iv) of this section as if the person had transferred its interest in the PFIC stock to the trust. However, the stock will be treated as stock of a PFIC that is not a QEF with respect to other beneficiaries of the

trust, unless the trust makes the section 1295 election as provided in paragraph (d)(2)(iii)(A)(*1*) of this section.

(B) *Foreign trust or estate—(1) Nongrantor trust or estate.* A U.S. person that is a beneficiary of a foreign nongrantor trust or estate that holds an interest in stock of a PFIC makes the section 1295 election with respect to that PFIC. A beneficiary's section 1295 election applies to all the PFIC stock owned directly and indirectly by the trust or estate and to the other PFIC stock owned directly or indirectly by the beneficiary. A section 1295 election by a beneficiary applies only to that beneficiary.

(*2*) *Grantor trust.* A U.S. person that is treated under sections 671 through 679 as the owner of the portion of a foreign trust that owns an interest in stock of a PFIC stock makes the section 1295 election with respect to that PFIC. If that person ceases to be treated as the owner of the portion of the trust that owns an interest in the PFIC stock and is a beneficiary of the trust, that person's section 1295 election will continue to apply to the PFIC stock indirectly owned by that person under the rules of paragraph (c)(2)(iv) of this section. However, as provided in paragraph (d)(2)(iii)(B)(*1*) of this section, any other shareholder that is a beneficiary of the trust and that wishes to treat the PFIC as a QEF must make the section 1295 election.

(iv) *Indirect ownership of the pass through entity or the PFIC.* The rules of this paragraph (d)(2) apply whether or not the shareholder holds its interest in the pass through entity directly or indirectly and whether or not the pass through entity holds its interest in the PFIC directly or indirectly.

(3) *Indirect ownership of a PFIC through other PFIC*s—(i) *In general.* An election under section 1295 shall apply only to the foreign corporation for which an election is made. Therefore, if a shareholder makes an election under section 1295 to treat a PFIC as a QEF, that election applies only to stock in that foreign corporation and not to the stock in any other corporation which the shareholder is treated as owning by virtue of its ownership of stock in the QEF.

(ii) *Example.* The following example illustrates the rules of paragraph (d)(3)(i) of this section:

Example. In 1988, T, a U.S. person, purchased stock of FC, a foreign corporation that is a PFIC. FC also owns the stock of SC, a foreign corporation that is a PFIC. T makes an election under section 1295 to treat FC as a QEF. T's section 1295 election applies only to the stock T owns in FC, and does not apply to the stock T indirectly owns in SC.

(4) *Member of consolidated return group as shareholder.* Pursuant to §1.1502–77(a), the common parent of an affiliated group of corporations that join in filing a consolidated income tax return makes a section 1295 election for all members of the affiliated group. An election by a common parent will be effective for all members of the affiliated group with respect to interests in PFIC stock held at the time the election is made or at any time thereafter. A separate election must be made by the common parent for each PFIC of which a member of the affiliated group is a shareholder.

(5) *Option holder.* A holder of an option to acquire stock of a PFIC may not make a section 1295 election that will apply to the option or to the stock subject to the option.

(6) *Exempt organization.* A tax-exempt organization that is not taxable under section 1291, pursuant to §1.1291–1(e), with respect to a PFIC may not make a section 1295 election with respect to that PFIC. In addition, such an exempt organization will not be subject to any section 1295 election made by a domestic pass through entity.

(e) *Time for making a section 1295 election—(1) In general.* Except as provided in §1.1295–3, a shareholder making the section 1295 election must make the election on or before the due date, as extended under section 6081 (election due date), for filing the shareholder's income tax return for the first taxable year to which the election will apply. The section 1295 election must be made in the original return for that year, or in an amended return, provided the amended return is filed on or before the election due date.

(2) *Examples.* The following examples illustrate the rules of paragraph (e)(1) of this section:

Example 1. In 1998, C, a domestic corporation, purchased stock of FC, a foreign corporation that is a PFIC. Both C and FC are calendar year taxpayers. C wishes to make the section 1295 election for its taxable year ended December 31, 1998. The section 1295 election must be made on or before March 15, 1999, the due date of C's 1998 income tax return as provided by section 6072(b). On March 14, 1999, C files a request for a three-month extension of time to file its 1998 income tax return under section 6081(b). C's time to file its 1998 income tax return and to make the section 1295 election is thereby extended to June 15, 1999.

Example 2. The facts are the same as in *Example 1* except that on May 1, 1999, C filed its 1998 income tax return and failed to include the section 1295 election. C may file an amended income tax return for 1998 to make the section 1295 election provided the amended return is filed on or before the extended due date of June 15, 1999.

(f) *Manner of making a section 1295 election and the annual election requirements of the shareholder*—(1) *Manner of making the election*. A shareholder must make a section 1295 election by—

(i) Completing Form 8621 in the manner required by that form and this section for making the section 1295 election;

(ii) Attaching Form 8621 to its Federal income tax return filed by the election due date for the shareholder's election year; and

(iii) Receiving and reflecting in Form 8621 the information provided in the PFIC Annual Information Statement described in paragraph (g)(1) of this section, the Annual Intermediary Statement described in paragraph (g)(3) of this section, or the applicable combined statement described in paragraph (g)(4) of this section, for the taxable year of the PFIC ending with or within the taxable year for which Form 8621 is being filed. If the PFIC Annual Information Statement contains a statement described in paragraph (g)(1)(ii)(C) of this section, the shareholder must attach a statement to Form 8621 that indicates that the shareholder rather than the PFIC calculated the PFIC's ordinary earnings and net capital gain.

(2) *Annual election requirements*—(i) *In general*. A shareholder that makes a section 1295 election with respect to a PFIC held directly or indirectly, for each taxable year to which the section 1295 election applies, must—

(A) Complete Form 8621 in the manner required by that form and this section;

(B) Attach Form 8621 to its Federal income tax return filed by the due date of the return, as extended; and

(C) Receive and reflect in Form 8621 the PFIC Annual Information Statement described in paragraph (g)(1) of this section, the Annual Intermediary Statement described in paragraph (g)(3) of this section, or the applicable combined statement described in paragraph (g)(4) of this section, for the MTtaxable year of the PFIC ending with or within the taxable year for which Form 8621 is being filed. If the PFIC Annual Information Statement contains a statement described in paragraph (g)(1)(ii)(C) of this section, the shareholder must attach a statement to its Form 8621 that the shareholder rather than the PFIC provided the calculations of the PFIC's ordinary earnings and net capital gain.

(ii) *Retention of documents*. For all taxable years subject to the section 1295 election, the shareholder must retain copies of all Forms 8621, with their attachments, and PFIC Annual Information Statements or Annual Intermediary Statements. Failure to produce those documents at the request of the Commissioner in connection with an examination may result in invalidation or termination of the shareholder's section 1295 election.

(3) *Effective date*. See paragraph (k) of this section for special applicability date of paragraph (f) of this section.

(g) *Annual election requirements of the PFIC or intermediary*—(1) *PFIC Annual Information Statement*. For each year of the PFIC ending in a taxable year of a shareholder to which the shareholder's section 1295 election applies, the PFIC must provide the shareholder with a PFIC Annual Information Statement. The PFIC Annual Information Statement is a statement of the PFIC, signed by the PFIC or an authorized representative of the PFIC, that contains the following information and representations—

(i) The first and last days of the taxable year of the PFIC to which the

PFIC Annual Information Statement applies;

(ii) Either—

(A) The shareholder's pro rata shares of the ordinary earnings and net capital gain (as defined in §1.1295–1(a)(2)) of the PFIC for the taxable year indicated in paragraph (g)(1)(i) of this section; or

(B) Sufficient information to enable the shareholder to calculate its pro rata shares of the PFIC's ordinary earnings and net capital gain, for that taxable year; or

(C) A statement that the foreign corporation has permitted the shareholder to examine the books of account, records, and other documents of the foreign corporation for the shareholder to calculate the amounts of the PFIC's ordinary earnings and the net capital gain according to Federal income tax accounting principles and to calculate the shareholder's pro rata shares of the PFIC's ordinary earnings and net capital gain;

(iii) The amount of cash and the fair market value of other property distributed or deemed distributed to the shareholder during the taxable year of the PFIC to which the PFIC Annual Information Statement pertains; and

(iv) Either—

(A) A statement that the PFIC will permit the shareholder to inspect and copy the PFIC's permanent books of account, records, and such other documents as may be maintained by the PFIC to establish that the PFIC's ordinary earnings and net capital gain are computed in accordance with U.S. income tax principles, and to verify these amounts and the shareholder's pro rata shares thereof; or

(B) In lieu of the statement required in paragraph (g)(1)(iv)(A) of this section, a description of the alternative documentation requirements approved by the Commissioner, with a copy of the private letter ruling and the closing agreement entered into by the Commissioner and the PFIC pursuant to paragraph (g)(2) of this section.

(2) *Alternative documentation*. In rare and unusual circumstances, the Commissioner will consider alternative documentation requirements necessary to verify the ordinary earnings and net capital gain of a PFIC other than the documentation requirements described in paragraph (g)(1)(iv)(A) of this section. Alternative documentation requirements will be allowed only pursuant to a private letter ruling and a closing agreement entered into by the Commissioner and the PFIC describing an alternative method of verifying the PFIC's ordinary earnings and net capital gain. If the PFIC has not obtained a private letter ruling from the Commissioner approving an alternative method of verifying the PFIC's ordinary earnings and net capital gain by the time a shareholder is required to make a section 1295 election, the shareholder may not use an alternative method for that taxable year.

(3) *Annual Intermediary Statement*. In the case of a U.S. person that is an indirect shareholder of a PFIC that is owned through an intermediary, as defined in paragraph (j) of this section, an Annual Intermediary Statement issued by an intermediary containing the information described in paragraph (g)(1) of this section and reporting the indirect shareholder's pro rata share of the ordinary earnings and net capital gain of the QEF as described in paragraph (g)(1)(ii)(A) of this section, may be provided to the indirect shareholder in lieu of the PFIC Annual Information Statement if the following conditions are satisfied—

(i) The intermediary receives a copy of the PFIC Annual Information Statement or the intermediary receives an annual intermediary statement from another intermediary which contains a statement that the other intermediary has received a copy of the PFIC Annual Information Statement and represents that the conditions of paragraphs (g)(3)(ii) and (g)(3)(iii) of this section are met;

(ii) The representations and information contained in the Annual Intermediary Statement reflect the representations and information contained in the PFIC Annual Information Statement; and

(iii) The PFIC Annual Information Statement issued to the intermediary contains either the representation set forth in paragraph (g)(1)(iv)(A) of this section, or, if alternative documentation requirements were approved by

the Commissioner pursuant to paragraph (g)(2) of this section, a copy of the private letter ruling and closing agreement between the Commissioner and the PFIC, agreeing to an alternative method of verifying PFIC ordinary earnings and net capital gain as described in paragraph (g)(2) of this section;

(4) *Combined statements*—(i) *PFIC Annual Information Statement*. A PFIC that owns directly or indirectly any stock of one or more PFICs with respect to which a shareholder may make the section 1295 election may prepare a PFIC Annual Information Statement that combines with its own information and representations the information and representations of all the PFICs. The PFIC may use any format for a combined PFIC Annual Information Statement provided the required information and representations are separately stated and identified with the respective corporations.

(ii) *Annual Intermediary Statement*. An intermediary described in paragraph (g)(3) of this section that owns directly or indirectly stock of one or more PFICs with respect to which an indirect shareholder may make the section 1295 election may prepare an Annual Intermediary Statement that combines with its own information and representations the information and representations with respect to all the PFICs. The intermediary may use any format for a combined Annual Intermediary Statement provided the required information and representations are separately stated and identified with the intermediary and the respective corporations.

(5) *Effective date*. See paragraph (k) of this section for special applicability date of paragraph (g) of this section.

(h) *Transition rules*. Taxpayers may rely on Notice 88–125 (1988–2 C.B. 535) (see § 601.601(d)(2) of this chapter), for rules on making and maintaining elections for shareholder election years (as defined in paragraph (j) of this section) beginning after December 31, 1986, and before January 1, 1998. Elections made under Notice 88–125 must be maintained as provided in § 1.1295–1 for taxable years beginning after December 31, 1997. A section 1295 election made prior to February 2, 1998 that was intended to be effective for the taxable year of the PFIC that began during the shareholder's election year will be effective for that taxable year of the foreign corporation provided that it is clear from all the facts and circumstances that the shareholder intended the election to be effective for that taxable year of the foreign corporation.

(i) *Invalidation, termination, or revocation of section 1295 election*—(1) *Invalidation or termination of election at the discretion of the Commissioner*—(i) *In general*. The Commissioner, in the Commissioner's discretion, may invalidate or terminate a section 1295 election applicable to a shareholder if the shareholder, the PFIC, or any intermediary fails to satisfy the requirements for making a section 1295 election or the annual election requirements of this section to which the shareholder, PFIC, or intermediary is subject, including the requirement to provide, on request, copies of the books and records of the PFIC or other documentation substantiating the ordinary earnings and net capital gain of the PFIC.

(ii) *Deferral of section 1293 inclusion*. The Commissioner may invalidate any pass through entity section 1295 election with respect to an interest holder or beneficiary if the section 1293 inclusion with respect to that interest holder or beneficiary is not included in the gross income of either the pass through entity, an intermediate pass through entity, or the interest holder or beneficiary within two years of the end of the PFIC's taxable year due to nonconforming taxable years of the interest holder and the pass through entity or any intermediate pass through entity.

(iii) *When effective*. Termination of a shareholder's section 1295 election will be effective for the taxable year of the PFIC determined by the Commissioner in the Commissioner's discretion. An invalidation of a shareholder's section 1295 election will be effective for the first taxable year to which the section 1295 election applied, and the shareholder whose election is invalidated will be treated as if the section 1295 election was never made.

(2) *Shareholder revocation*—(i) *In general*. In the Commissioner's discretion, upon a finding of a substantial change

in circumstances, the Commissioner may consent to a shareholder's request to revoke a section 1295 election. Request for revocation must be made by the shareholder that made the election and at the time and in the manner provided in paragraph (i)(2)(ii) of this section.

(ii) *Time for and manner of requesting consent to revoke*—(A) *Time*. The shareholder must request consent to revoke the section 1295 election no later than 12 calendar months after the discovery of the substantial change of circumstances that forms the basis for the shareholder's request to revoke the section 1295 election.

(B) *Manner of making request*. A shareholder requests consent to revoke a section 1295 election by filing a ruling request with the Office of the Associate Chief Counsel (International). The ruling request must satisfy the requirements, including payment of the user fee, for filing ruling requests with that office.

(iii) *When effective*. Unless otherwise determined by the Commissioner, revocation of a section 1295 election will be effective for the first taxable year of the PFIC beginning after the date the Commissioner consents to the revocation.

(3) *Automatic termination*. If a United States person, or the United States shareholder on behalf of a controlled foreign corporation, makes an election pursuant to section 1296 and the regulations thereunder with respect to PFIC stock for which a QEF election is in effect, or marks to market such stock under another provision of chapter 1 of the Internal Revenue Code, the QEF election is automatically terminated with respect to such stock that is marked to market under section 1296 or another provision of chapter 1 of the Internal Revenue Code. Such termination shall be effective on the last day of the shareholder's taxable year preceding the first taxable year for which the section 1296 election is in effect or such stock is marked to market under another provision of chapter 1 of the Internal Revenue Code.

Example. Corp Y, a domestic corporation, owns directly 100 shares of marketable stock in foreign corporation FX, a PFIC. Corp Y also owns a 50 percent interest in FP, a foreign partnership that owns 200 shares of FX stock. Accordingly, under section 1298(a)(3) and §1.1296–1(e)(1), Corp Y is treated as indirectly owning 100 shares of FX stock. Corp Y also owns 100 percent of the stock of FZ, a foreign corporation that is not a PFIC. FZ owns 100 shares of FX stock, and therefore under section 1298(a)(2)(A), Corp Y is treated as owning the 100 shares of FX stock owned by FZ. For taxable year 2005, Corp Y has a QEF election in effect with respect to all 300 shares of FX stock that it owns directly or indirectly. See generally §1.1295–1(c)(1). For taxable year 2006, Corp Y makes a timely election pursuant to section 1296 and the regulations thereunder. For purposes of section 1296, Corp Y is treated as owning stock held indirectly through a partnership, but not through a foreign corporation. Section 1296(g); §1.1296–1(e)(1). Accordingly, Corp Y's section 1296 election covers the 100 shares it owns directly and the 100 shares it owns indirectly through FP, but not the 100 shares owned by FZ. With respect to the first 200 shares, Corp Y's QEF election is automatically terminated effective December 31, 2005. With respect to the 100 shares Corp Y owns through foreign FZ, Corp Y's QEF election remains in effect unless invalidated, terminated, or revoked pursuant to this paragraph (i).

(4) *Effect of invalidation, termination, or revocation*. An invalidation, termination, or revocation of a section 1295 election—

(i) Terminates all section 1294 elections, as provided in §1.1294–1T(e), and the undistributed PFIC earnings tax liability and interest thereon are due by the due date, without regard to extensions, for the return for the last taxable year of the shareholder to which the section 1295 election applies;

(ii) In the Commissioner's discretion, results in a deemed sale of the QEF stock on the last day of the PFIC's last taxable year as a QEF, in which gain, but not loss, will be recognized and with respect to which appropriate basis and holding period adjustments will be made; and

(iii) Subjects the shareholder to any other terms and conditions that the Commissioner determines are necessary to ensure the shareholder's compliance with sections 1291 through 1298 or any other provisions of the Code.

(5) *Effect after invalidation, termination, or revocation*—(i) *In general*. Without the Commissioner's consent, a shareholder whose section 1295 election was invalidated, terminated, or revoked under this paragraph (i) may not

make the section 1295 election with respect to the PFIC before the sixth taxable year in which the invalidation, termination, or revocation became effective.

(ii) *Special rule.* Notwithstanding paragraph (i)(5)(i) of this section, a shareholder whose section 1295 election was terminated pursuant to paragraph (i)(3) of this section, and either whose section 1296 election has subsequently been terminated because its PFIC stock ceased to be marketable or who no longer marks to market such stock under another provision of chapter 1 of the Internal Revenue Code, may make a section 1295 election with respect to its PFIC stock before the sixth taxable year in which its prior section 1295 election was terminated.

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

Intermediary is a nominee or shareholder of record that holds stock on behalf of the shareholder or on behalf of another person in a chain of ownership between the shareholder and the PFIC, and any direct or indirect beneficial owner of PFIC stock (including a beneficial owner that is a pass through entity) in the chain of ownership between the shareholder and the PFIC.

Pass through entity is a partnership, S corporation, trust, or estate.

Shareholder has the same meaning as the term shareholder in §1.1291–9(j)(3), except that for purposes of this section, a partnership and an S corporation also are treated as shareholders. Furthermore, unless otherwise provided, an interest holder of a pass through entity, which is treated as a shareholder of a PFIC, also will be treated as a shareholder of the PFIC.

Shareholder's election year is the taxable year of the shareholder for which it made the section 1295 election.

(k) *Effective dates.* Except as otherwise provided, paragraphs (b)(2)(iii), (b)(3), (b)(4), and (c) through (j) of this section are applicable to taxable years of shareholders beginning after December 31, 1997. However, taxpayers may apply the rules under paragraphs (b)(4), (f) and (g) of this section to a taxable year beginning before January 1, 1998, provided the statute of limitations on the assessment of tax has not expired as of April 27, 1998, and, in the case of paragraph (b)(4) of this section, the taxpayers who filed the joint return have consistently applied the rules of that section to all taxable years following the year the election was made. Paragraph (b)(3)(v) of this section is applicable as of February 7, 2000, however, a taxpayer may apply the rules to a taxable year prior to the applicable date provided the statute of limitations on the assessment of tax for that taxable year has not expired. Paragraphs (i)(3) and (i)(5)(ii) of this section are applicable for taxable years beginning on or after May 3, 2004.

[T.D. 8750, 63 FR 15, Jan. 2, 1998. Redesignated and amended by T.D. 8870, 65 FR 5779, 5781, Feb. 7, 2000; T.D. 9123, 69 FR 24073, May 3, 2004]

§ 1.1295–3 Retroactive elections.

(a) *In general.* This section prescribes the exclusive rules under which a shareholder, as defined in §1.1295–1(j), may make a section 1295 election for a taxable year after the election due date, as defined in §1.1295–1(e) (retroactive election). Therefore, a shareholder may not seek such relief under any other provision of the law, including §301.9100 of this chapter. Paragraph (b) of this section describes the general rules for a shareholder to preserve the ability to make a retroactive election. These rules require that the shareholder possess reasonable belief as of the election due date that the foreign corporation was not a PFIC for its taxable year that ended in the shareholder's taxable year to which the election due date pertains, and that the shareholder file a Protective Statement to preserve its ability to make a retroactive election. Paragraph (c) of this section establishes the terms, conditions and other requirements with respect to a Protective Statement required to be filed under the general rules. Paragraph (d) of this section sets forth factors that establishes a shareholder's reasonable belief that a foreign corporation was not a PFIC. Paragraph (e) of this section prescribes special rules for certain shareholders that are deemed to satisfy the reasonable belief requirement and therefore are not required to file a Protective Statement. Paragraph (f) of this section describes the limited circumstances

under which the Commissioner may permit a shareholder that lacked the requisite reasonable belief or failed to satisfy the requirements of paragraph (b) or (e) of this section to make a retroactive election. Paragraph (g) of this section provides the time for and manner of making a retroactive election. Paragraph (h) of this section provides the effective date of this section.

(b) *General rule.* Except as provided in paragraphs (e) and (f) of this section, a shareholder may make a retroactive election for a taxable year of the shareholder (retroactive election year) only if the shareholder—

(1) Reasonably believed, within the meaning of paragraph (d) of this section, that as of the election due date, as defined in §1.1295–1(e), the foreign corporation was not a PFIC for its taxable year that ended during the retroactive election year;

(2) Filed a Protective Statement with respect to the foreign corporation, applicable to the retroactive election year, in which the shareholder described the basis for its reasonable belief and extended, in the manner provided in paragraph (c)(4) of this section, the periods of limitations on the assessment of taxes determined under sections 1291 and 1298 with respect to the foreign corporation (PFIC related taxes) for all taxable years of the shareholder to which the Protective Statement applies; and

(3) Complied with the other terms and conditions of the Protective Statement.

(c) *Protective Statement*—(1) *In general.* A Protective Statement is a statement executed under penalties of perjury by the shareholder, or a person authorized to sign a Federal income tax return on behalf of the shareholder, that preserves the shareholder's ability to make a retroactive election. To file a Protective Statement that applies to a taxable year of the shareholder, the shareholder must reasonably believe as of the election due date that the foreign corporation was not a PFIC for the foreign corporation's taxable year that ended during the retroactive election year. The Protective Statement must contain—

(i) The shareholder's reasonable belief statement, as described in paragraph (c)(2) of this section;

(ii) The shareholder's agreement extending the periods of limitations on the assessment of PFIC related taxes for all taxable years to which the Protective Statement applies, as provided in paragraph (c)(4) of this section; and

(iii) The following information and representations—

(A) The shareholder's name, address, taxpayer identification number, and the shareholder's first taxable year to which the Protective Statement applies;

(B) The foreign corporation's name, address, and taxpayer identification number, if any; and

(C) The highest percentage of shares of each class of stock of the foreign corporation held directly or indirectly by the shareholder during the shareholder's first taxable year to which the Protective Statement applies.

(2) *Reasonable belief statement.* The Protective Statement must contain a reasonable belief statement, as described in paragraph (c)(1) of this section. The reasonable belief statement is a description of the shareholder's basis for its reasonable belief that the foreign corporation was not a PFIC for its taxable year that ended with or within the shareholder's first taxable year to which the Protective Statement applies. If the Protective Statement applies to a taxable year or years described in paragraph (c)(5)(ii) of this section, the reasonable belief statement must describe the shareholder's basis for its reasonable belief that the foreign corporation was not a PFIC for the foreign corporation's taxable year or years that ended in such taxable year or years of the shareholder. The reasonable belief statement must discuss the application of the income and asset tests to the foreign corporation and the factors, including those stated in paragraph (d) of this section, that affect the results of those tests.

(3) *Who executes and files the Protective Statement.* The person that executes and files and Protective Statement is the person that makes the section 1295 election, as provided in §1.1295–1(d).

(4) *Waiver of the periods of limitations*—(i) *Time for and manner of extending periods of limitations.* (A) *In general.* A shareholder that files the Protective Statement with the Commissioner must extend the periods of limitations on the assessment of all PFIC related taxes for all of the shareholder's taxable years to which the Protective Statement applies, as provided in this paragraph (c)(4). The shareholder is required to execute the waiver on such form as the Commission may prescribe for purposes of this paragraph (c)(4). Until that form is published, the shareholder must execute a statement in which the shareholder agrees to extend the periods of limitations on the assessment of all PFIC related taxes for all the shareholder's taxable years to which the Protective Statement applies, as provided in this paragraph (c)(4), and agrees to the restrictions in paragraph (c)(4)(ii)(A) of this section. The shareholder or a person authorized to sign the shareholder's Federal income tax return must sign the form or statement. A properly executed form or statement authorized by this paragraph (c)(4) will be deemed consented to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)–1(d) of this chapter.

(B) *Application of general rule to domestic partnerships*— (*1*) *In general.* A domestic partnership that holds an interest in stock of a PFIC satisfies the waiver requirement of paragraph (c)(4) of this section pursuant to the rules of this paragraph (c)(4)(i)(B)(*1*). The partnership must file one or more waivers obtained or arranged under this paragraph (c)(4)(i)(B) as part of the Protective Statement, as provided in paragraph (c)(1) of this section. The partnership must either—

(*i*) Obtain from each partner the partner's waiver of the periods of limitations;

(*ii*) Obtain from each partner a duly executed power of attorney under § 601.501 of this chapter authorizing the partnership to extend that partner's periods of limitations, and execute a waiver on behalf of the partners; or

(*iii*) In the case of a domestic partnership governed by the unified audit and litigation procedures of sections 6221 through 6233 (TEFRA partnership), arrange for the tax matters partner (or any other person authorized to enter into an agreement to extend the periods of limitations), as provided in section 6229(b), to execute a waiver on behalf of all the partners.

(*2*) *Special rules*—(*i*) *Addition of partner to non-TEFRA partnership.* In the case of any individual who becomes a partner in a domestic partnership other than a TEFRA partnership (non-TEFRA partnership) in a taxable year subsequent to the year in which the partnership filed a Protective Statement, the partner and the partnership must comply with the rules applicable to non-TEFRA partnerships, as provided in paragraph (c)(4)(i)(B)(*1*) of this section, by the due date, as extended, for the Federal income tax return of the partnership for the taxable year during which the individual became a partner. Failure to so comply will render the Protective Statement invalid with respect to the partnership and partners.

(*ii*) *Change in status from non-TEFRA partnership to TEFRA partnership.* If a partnership is a non-TEFRA partnership in one taxable year but becomes a TEFRA partnership in a subsequent taxable year, the partnership must file one or more waivers obtained or arranged under this paragraph (c)(4)(i)(B)(*2*)(*ii*), as part of the Protective Statement, as provided in paragraph (c)(1) of this section. The partnership must either—obtain from any new partner the partner's waiver described in this paragraph (c)(4); obtain from the new partner a duly executed power of attorney under § 601.501 of this chapter authorizing the partnership to extend the partner's periods of limitations, and execute a waiver on behalf of the new partner; or arrange for the tax matters partner (or any other person authorized to enter into an agreement to extend the periods of limitations) to execute a waiver on behalf of all the partners. In each case, the partnership must attach any new waiver of a partner's periods of limitations, and a copy of the Protective Statement to its Federal income tax return for that taxable year.

(C) *Application of general rule to domestic nongrantor trusts and domestic estates.* A domestic nongrantor trust or a domestic estate that holds an interest in stock of a PFIC satisfies the waiver requirement of this paragraph (c)(4) at the entity level. For this purpose, such entity must comply with rules similar to those applicable to non-TEFRA partnerships, as provided in paragraph (c)(4)(i)(B)(*1*) of this section.

(D) *Application of general rule to S corporations.* An S corporation that holds an interest in stock of a PFIC satisfies the waiver requirement of this paragraph (c)(4) at the S corporation level. For this purpose, the S corporation must comply with rules similar to those applicable to non-TEFRA partnerships, as provided in paragraph (c)(4)(i)(B)(*1*) of this section. However, in the case of an S corporation that was governed by the unified audit corporate proceedings of sections 6241 through 6245 for any taxable year to which a Protective Statement applies (former TEFRA S corporation), the tax matters person (or any other person authorized to enter into such an agreement), as was provided in sections 6241 through 6245, may execute a waiver described in this paragraph (c)(4) that applies to such taxable year; for any other taxable year, the former TEFRA S corporation must comply with rules similar to those applicable to non-TEFRA partnerships.

(E) *Effect on waiver of complete termination of a pass through entity or pass through entity's business.* The complete termination of a pass through entity described in paragraphs (c)(4)(i) (B) through (D) of this section, or a pass through entity's trade or business, will not terminate a waiver that applies to a partner, shareholder, or beneficiary.

(F) *Application of general rule to foreign partnerships, foreign trusts, domestic or foreign grantor trusts, and foreign estates.* A U.S. person that is a partner or beneficiary of a foreign partnership, foreign trust, or foreign estate that holds an interest in stock of a PFIC satisfies the waiver requirement of this paragraph (c)(4) at the partner or beneficiary level. A U.S. person that is treated under sections 671 through 679 as the owner of the portion of a domestic or foreign trust that owns an interest in PFIC stock also satisfies the waiver requirement at the owner level. A waiver by a partner or beneficiary applies only to that partner or beneficiary, and is not affected by a complete termination of the entity or the entity's trade or business.

(ii) *Terms of waiver*—(A) *Scope of waiver.* The waiver of the periods of limitations is limited to the assessment of PFIC related taxes. If the period of limitations for a taxable year affected by a retroactive election has expired with respect to the assessment of other non-PFIC related taxes, no adjustments, other than consequential changes, may be made by the Internal Revenue Service or by the shareholder to any other item of income, deduction, or credit for that year. If the period of limitations for refunds or credits for a taxable year affected by a retroactive election is open only by virtue of the assessment period extension and section 6511(c), no refund or credit is allowable on grounds other than adjustments to PFIC related taxes and consequential changes.

(B) *Period of Waiver.* The extension of the periods of limitations on the assessment of PFIC related taxes will be effective for all of the shareholder's taxable years to which the Protective Statement applies. In addition, the waiver, to the extent it applies to the period of limitations for a particular year, will terminate with respect to that year no sooner than three years from the date on which the shareholder files an amended return, as provided in paragraph (g) of this section, for that year. For the suspension of the running of the period of limitations for the collection of taxes for which a shareholder has elected under section 1294 to extend the time for payment, as provided in paragraph (g)(3)(ii) of this section, see sections 6503(i) and 6229(h).

(5) *Time of and manner for filing a Protective Statement*—(i) *In general.* Except as provided in paragraph (c)(5)(ii) of this section, a Protective Statement must be attached to the shareholder's federal income tax return for the shareholder's first taxable year to which the Protective Statement will apply. The shareholder must file its return and the copy of the Protective

Statement by the due date, as extended under section 6081, for the return.

(ii) *Special rule for taxable years ended before January 2, 1998.* A shareholder may file a Protective Statement that applies to the shareholder's taxable year or years that ended before January 2, 1998, provided the period of limitations on the assessment of taxes for any such year has not expired (open year). The shareholder must file the Protective Statement applicable to such open year or years, as provided in paragraph (c)(5)(i) of this section, by the due date, as extended, for the shareholder's return for the first taxable year ending after January 2, 1998.

(6) *Applicability of the Protective Statement*—(i) *In general.* Except as otherwise provided in this paragraph (c)(6), a Protective Statement applies to the shareholder's first taxable year for which the Protective Statement was filed and to each subsequent taxable year. The Protective Statement will not apply to any taxable year of the shareholder during which the shareholder does not own any stock of the foreign corporation or to any taxable year thereafter. Accordingly, if the shareholder has not made a retroactive election with respect to the previously owned stock by the time the shareholder reacquires stock of the foreign corporation, the shareholder must file another Protective Statement to preserve its right to make a retroactive election with respect to the later acquired stock. For the rule that provides that a section 1295 election made with respect to a foreign corporation applies to stock of that corporation acquired after a lapse in ownership, see §1.1295–1(c)(2)(iii).

(ii) *Invalidity of the Protective Statement.* A shareholder will be treated as if it never filed a Protective Statement if—

(A) The shareholder failed to make a retroactive election by the date prescribed for making the retroactive election in paragraph (g)(1) of this section; or

(B) The waiver of the periods of limitations terminates (by reason of a court decision or other determination) with respect to any taxable year before the expiration of three years from the date of filing of an amended return for that year pursuant to paragraph (g) of this section.

(7) *Retention of Protective Statement and information demonstrating reasonable belief.* A shareholder that files a Protective Statement must retain a copy of the Protective Statement and its attachments and must, for each taxable year of the shareholder to which the Protective Statement applies, retain information sufficient to demonstrate the shareholder's reasonable belief that the foreign corporation was not a PFIC for the taxable year of the foreign corporation ending during each such taxable year of the shareholder.

(d) *Reasonable belief*—(1) *In general.* A foreign corporation is a PFIC for a taxable year if the foreign corporation satisfies either the income or asset test of section 1297(a). To determine whether a shareholder had reasonable belief that the foreign corporation is not a PFIC under section 1297(a), the shareholder must consider all relevant facts and circumstances. Reasonable belief may be based on a variety of factors, including reasonable asset valuations as well as reasonable interpretations of the applicable provisions of the Code, regulations, and administrative guidance regarding the direct and indirect ownership of the income or assets of the foreign corporation, the proper character of that income or those assets, and similar issues. Reasonable belief may be based on reasonable predictions regarding income to be earned and assets to be owned in subsequent years where qualifications of the foreign corporation as a PFIC for the current taxable year will depend on the qualification of the corporation as a PFIC in a subsequent year. Reasonable belief may be based on an analysis of generally available financial information of the foreign corporation. To determine whether a shareholder had reasonable belief that the foreign corporation was not a PFIC, the Commissioner may consider the size of the shareholder's interest in the foreign corporation.

(2) *Knowledge of law required.* Reasonable belief must be based on a good faith effort to apply the Code, regulations, and related administrative guidance. Any person's failure to know or apply these provisions will not form the basis of reasonable belief.

(e) *Special rules for qualified shareholders*—(1) *In general.* A shareholder that is a qualified shareholder, as defined in paragraph (e)(2) of this section, for a taxable year of the shareholder is not required to satisfy the reasonable belief requirement of paragraph (b)(1) of this section or file a Protective Statement to preserve its ability to make a retroactive election with respect to such taxable year. Accordingly, a qualified shareholder may make a retroactive election for any open taxable year in the shareholder's holding period. The retroactive election will be treated as made in the earliest taxable year of the shareholder during which the foreign corporation qualified as a PFIC (including a taxable year ending prior to January 2, 1998) and the shareholder will be treated as a shareholder of a pedigreed QEF, as defined in § 1.1291–9(j)(2)(ii), provided the shareholder—

(i) Has been a qualified shareholder with respect to the foreign corporation for all taxable years of the shareholder included in the shareholder's holding period during which the foreign corporation was a PFIC, or in the case of taxable years ending before January 2, 1998, the shareholder satisfies the criteria of a qualified shareholder, for all such years; or

(ii) Has been a qualified shareholder, or in the case of taxable years ending before January 2, 1998 satisfies the criteria of a qualified shareholder, for all taxable years in its holding period before it filed a Protective Statement, which Protective Statement is applicable to all subsequent years, beginning with the first taxable year in which the shareholder is not a qualified shareholder.

(2) *Qualified shareholder.* A shareholder will be treated as a qualified shareholder for a taxable year if the shareholder did not file a Protective Statement applicable to an earlier taxable year included in the shareholder's holding period of the stock of the foreign corporation currently held and—

(i) At all times during the taxable year the shareholder owned, within the meaning of section 958, directly, indirectly, or constructively, less than two percent of the vote and value of each class of stock of the foreign corporation; and

(ii) With respect to the taxable year of the foreign corporation ending within the shareholder's taxable year, the foreign corporation or U.S. counsel for the foreign corporation indicated in a public filing, disclosure statement or other notice provided to U.S. persons that are shareholders of the foreign corporation (corporate filing) that the foreign corporation—

(A) Reasonably believes that it is not or should not constitute a PFIC for the corporation's taxable year; or

(B) Is unable to conclude that it is not or should not be a PFIC (due to certain asset valuation or interpretation issues, or because PFIC status will depend on the income or assets of the foreign corporation in the corporation's subsequent taxable years) but reasonably believes that, more likely than not, it ultimately will not be a PFIC.

(3) *Exceptions.* Notwithstanding paragraph (e)(2)(ii) of this section, a shareholder will not be treated as a qualified shareholder for a taxable year of the shareholder if the shareholder knew or had reason to know that a corporate filing regarding the foreign corporation's PFIC status was inaccurate, or knew that the foreign corporation was a PFIC for the taxable year of the foreign corporation ending with or within such taxable year of the shareholder. For purposes of this paragraph, a shareholder will be treated as knowing that a foreign corporation was a PFIC if the principal activity of the foreign corporation, directly or indirectly, is owning or trading a diversified portfolio of stock, securities, or other financial contracts.

(f) *Special consent*—(1) *In general.* A shareholder that has not satisfied the requirements of paragraph (b) or (e) of this section may request the consent of the Commissioner to make a retroactive election for a taxable year of the shareholder provided the shareholder satisfies the requirements set forth in this paragraph (f). The Commissioner will grant relief under this paragraph (f) only if—

(i) The shareholder reasonably relied on a qualified tax professional, within

the meaning of paragraph (f)(2) of this section;

(ii) Granting consent will not prejudice the interests of the United States government, as provided in paragraph (f)(3) of this section;

(iii) The shareholder requests consent under paragraph (f) of this section before a representative of the Internal Revenue Service raises upon audit the PFIC status of the corporation for any taxable year of the shareholder; and

(iv) The shareholder satisfies the procedural requirements set forth in paragraph (f)(4) of this section.

(2) *Reasonable reliance on a qualified tax professional*—(i) *In general.* Except as provided in paragraph (f)(2)(ii) of this section, a shareholder is deemed to have reasonably relied on a qualified tax professional only if the shareholder reasonably relied on a qualified tax professional (including a tax professional employed by the shareholder) who failed to identify the foreign corporation as a PFIC or failed to advise the shareholder of the consequences of making, or failing to make, the section 1295 election. A shareholder will not be considered to have reasonably relied on a qualified tax professional if the shareholder knew, or reasonably should have known, that the foreign corporation was a PFIC and of the availability of a section 1295 election, or knew or reasonably should have known that the qualified tax professional—

(A) Was not competent to render tax advice with respect to the ownership of shares of a foreign corporation; or

(B) Did not have access to all relevant facts and circumstances.

(ii) *Shareholder deemed to have not reasonably relied on a qualified tax professional.* For purposes of this paragraph (f)(2), a shareholder is deemed to have not reasonably relied on a qualified tax professional if the shareholder was informed by the qualified tax professional that the foreign corporation was a PFIC and of the availability of the section 1295 election and related tax consequences, but either chose not to make the section 1295 election or was unable to make a valid section 1295 election.

(3) *Prejudice to the interests of the United States government*—(1) *General rule.* Except as otherwise provided in paragraph (f)(3)(ii) of this section, the Commissioner will not grant consent under paragraph (f) of this section if doing so would prejudice the interests of the United States government. The interests of the United States government are prejudiced if granting relief would result in the shareholder having a lower tax liability, taking into account applicable interest charges, in the aggregate for all years affected by the retroactive election (other than by a de minimis amount) than the shareholder would have had if the shareholder had made the section 1295 election by the election due date. The time value of money is taken into account for purposes of this computation.

(ii) *Elimination of prejudice to the interests of the United States government.* Notwithstanding the general rule of paragraph (f)(3)(i) of this section, if granting relief would prejudice the interests of the United States government, the Commissioner may, in the Commissioner's sole discretion, grant consent to make the election provided the shareholder enters into a closing agreement with the Commissioner that requires the shareholder to pay an amount sufficient to eliminate any prejudice to the United States government as a consequence of the shareholder's inability to file amended returns for closed taxable years.

(4) *Procedural requirements*—(i) *Filing instructions.* A shareholder requests consent under paragraph (f) of this section to make a retroactive election by filing with the Office of the Associate Chief Counsel (International) a ruling request that includes the affidavits required by this paragraph (f)(4). The ruling request must satisfy the requirements, including payment of the user fee, for ruling requests filed with that office.

(ii) *Affidavit from shareholder.* The shareholder, or a person authorized to sign a Federal income tax return on behalf of the shareholder, must submit a detailed affidavit describing the events that led to the failure to make a section 1295 election by the election due date, and to the discovery thereof. The shareholder's affidavit must describe the engagement and responsibilities of the qualified tax professional as well as

the extent to which the shareholder relied on the tax professional. The shareholder must sign the affidavit under penalties of perjury. An individual who signs for an entity must have personal knowledge of the facts and circumstances at issue.

(iii) *Affidavits from other persons.* The shareholder must submit detailed affidavits from individuals having knowledge or information about the events that led to the failure to make a section 1295 election by the election due date, and to the discovery thereof. These individuals must include the qualified tax professional upon whose advice the shareholder relied, as well as any individual (including an employee of the shareholder) who made a substantial contribution to the return's preparation, and any accountant or attorney, knowledgeable in tax matters, who advised the shareholder with regard to its ownership of the stock of the foreign corporation. Each affidavit must describe the individual's engagement and responsibilities as well as the advice concerning the tax treatment of the foreign corporation that that individual provided to the shareholder. Each affidavit also must include the individual's name, address, and taxpayer identification number, and must be signed by the individual under penalties of perjury.

(iv) *Other information.* In connection with a request for consent under this paragraph (f), a shareholder must provide any additional information requested by the Commissioner.

(v) *Notification of Internal Revenue Service.* The shareholder must notify the branch of the Associate Chief Counsel (International) considering the request for relief under this paragraph (f) if, while the shareholder's request for consent is pending, the Internal Revenue Service begins an examination of the shareholder's return for the retroactive election year or for any subsequent taxable year during which the shareholder holds stock of the foreign corporation.

(vi) *Who requests special consent under this paragraph (f) and who enters into a closing agreement.* The person that requests consent under this paragraph (f) is the person that makes the section 1295 election, as provided in §1.1295–1(d). If a shareholder is required to enter into a closing agreement with the Commissioner, as described in paragraph (f)(3)(ii) of this section, rules similar to those under paragraphs (c)(4)(i) (B) through (E) of this section apply for purposes of determining the person that enters into the closing agreement.

(g) *Time for and manner of making a retroactive election*—(1) *Time for making a retroactive election*—(i) *In general.* Except as otherwise provided in paragraph (g)(1)(ii) of this section, a shareholder must make a retroactive election, in the manner provided in paragraph (g)(2) of this section, on or before the due date, as extended, for the shareholder's return—

(A) In the case of a shareholder that makes a retroactive election pursuant to paragraph (b) or (e) of this section, for the taxable year in which the shareholder determines or reasonably should have determined that the foreign corporation was a PFIC; or

(B) In the case of a shareholder that obtains the consent of the Commissioner pursuant to paragraph (f) of this section for the taxable year in which such consent is granted.

(ii) *Transition rule.* A shareholder that files a Protective Statement for a taxable year described in paragraph (c)(5)(ii) of this section may make a retroactive election by the due date, as extended, for the return for the first taxable year ended after January 2, 1998 even if the shareholder determined or should have determined that the foreign corporation was a PFIC for a year described in paragraph (c)(5)(ii) of this section at any time on or before January 2, 1998.

(iii) *Ownership not required at time retroactive election is made.* The shareholder need not own shares of the foreign corporation at the time the shareholder makes a retroactive election with respect to the foreign corporation.

(2) *Manner of making a retroactive election.* A shareholder that has satisfied the requirements of paragraph (b) or (e) of this section, or a shareholder that has been granted consent under paragraph (f) of this section, must make a retroactive election in the manner provided in Form 8621 for making a section 1295 election, and must attach

Form 8621 to an amended return for the later of the retroactive election year or the earliest open taxable year of the shareholder. The shareholder also must file an amended return for each of its subsequent taxable years affected by the retroactive election. In each amended return the shareholder must redetermine its income tax liability for that year to take into account the assessment of PFIC related taxes. If the period of limitations for the assessment of taxes for a taxable year affected by the retroactive election has expired except to the extent the waiver of limitations, described in paragraph (c)(4) of this section, has extended such period, no adjustments, other than consequential changes, may be made to any other items of income, deduction, or credit in that year. In addition, the shareholder must pay all taxes and interest owing by reason of the PFIC and QEF status of the foreign corporation in those years (except to the extent a section 1294 election extends the time to pay the taxes and interest). A shareholder that filed a Protective Statement must attach to Form 8621 filed with each amended return a representation that the shareholder, until the taxable year in which it determined or reasonably should have determined that the foreign corporation was a PFIC, reasonably believed, within the meaning of paragraph (d) of this section, that the foreign corporation was not a PFIC in the taxable year for which the amended return is filed, and in all other taxable years to which the Protective Statement applies. A shareholder that entered into a closing agreement must comply with the terms of that agreement, as provided in paragraph (f)(3)(ii) of this section, to eliminate any prejudice to the United States government's interests, as described in paragraph (f)(3) of this section.

(3) *Who makes the retroactive election.* The person that makes the retroactive election is the person that makes the section 1295 election, as provided in § 1.1295–1(d). A partner, shareholder, or beneficiary for which a pass through entity, as described in paragraphs (c)(4)(i) (B) through (D) of this section, filed a Protective Statement may make a retroactive election, if the pass through entity completely terminates its business or otherwise ceases to exist.

(4) *Other elections*—(i) *Section 1291(d)(2) election.* If the foreign corporation for which the shareholder makes a retroactive election will be treated as an unpedigreed QEF, as defined in § 1.1291–9(j)(2)(iii), with respect to the shareholder, the shareholder may make an election under section 1291(d)(2) to purge its holding period of the years or parts of years before the effective date of the retroactive election. If the qualification date, within the meaning of § 1.1291–9(e) or 1.1291–10(e), falls in a taxable year for which the period of limitations has expired, the shareholder may treat the first day of the retroactive election year as the qualification date. The shareholder may make a section 1291(d)(2) election at the time that it makes the retroactive election, but no later than two years after the date that the amended return in which the retroactive election is made is filed. For the requirements for making a section 1291(d)(2) election, see §§ 1.1291–9 and 1.1291–10.

(ii) *Section 1294 election.* A shareholder may make an election under section 1294 to extend the time for payment of tax on the shareholder's pro rata shares of the ordinary earnings and net capital gain of the foreign corporation reported in the shareholder's amended return, and section 6621 interest attributable to such tax, but only to the extent the tax and interest are attributable to earnings that have not been distributed to the shareholder. The shareholder must make a section 1294 election for a taxable year at the time that it files its amended return for that year, as provided in paragraph (g)(1) of this section. For the requirements for making a section 1294 election, see § 1.1294–1T.

(h) *Effective date.* The rules of this section are effective as of January 2, 1998.

[T.D. 8750, 63 FR 19, Jan. 2, 1998. Redesignated and amended by T.D. 8870, 65 FR 5781, Feb. 7, 2000]

§ 1.1296–1 Mark to market election for marketable stock.

(a) *Definitions*—(1) *Eligible RIC.* An *eligible RIC* is a regulated investment company that offers for sale, or has

outstanding, any stock of which it is the issuer and which is redeemable at net asset value, or that publishes net asset valuations at least annually.

(2) *Section 1296 stock.* The term *section 1296 stock* means marketable stock in a passive foreign investment company (PFIC), including any PFIC stock owned directly or indirectly by an eligible RIC, for which there is a valid section 1296 election. Section 1296 stock does not include stock of a foreign corporation that previously had been a PFIC, and for which a section 1296 election remains in effect.

(3) *Unreversed inclusions*—(i) *General rule.* The term *unreversed inclusions* means with respect to any section 1296 stock, the excess, if any, of—

(A) The amount of mark to market gain included in gross income of the United States person under paragraph (c)(1) of this section with respect to such stock for prior taxable years; over

(B) The amount allowed as a deduction to the United States person under paragraph (c)(3) of this section with respect to such stock for prior taxable years.

(ii) *Section 1291 adjustment.* The amount referred to in paragraph (a)(3)(i)(A) of this section shall include any amount subject to section 1291 under the coordination rule of paragraph (i)(2)(ii) of this section.

(iii) *Example.* An example of the computation of unreversed inclusions is as follows:

Example. A, a United States person, acquired stock in Corp X, a foreign corporation, on January 1, 2005 for $150. At such time and at all times thereafter, Corp X was a PFIC and A's stock in Corp X was marketable. For taxable years 2005 and 2006, Corp X was a nonqualified fund subject to taxation under section 1291. A made a timely section 1296 election with respect to the X stock, effective for taxable year 2007. The fair market value of the X stock was $200 as of December 31, 2006, and $240 as of December 31, 2007. Additionally, Corp X made no distribution with respect to its stock for the taxable years at issue. In 2007, pursuant to paragraph (i)(2)(ii) of this section, A must include the $90 gain in the X stock in accordance with the rules of section 1291 for purposes of determining the deferred tax amount and any applicable interest. Nonetheless, for purposes of determining the amount of the unreversed inclusions pursuant to paragraph (a)(3)(ii) of this section, A will include the $90 of gain that was taxed under section 1291 and not the interest thereon.

(iv) *Special rule for regulated investment companies.* In the case of a regulated investment company which had elected to mark to market the PFIC stock held by such company as of the last day of the taxable year preceding such company's first taxable year for which such company makes a section 1296 election, the amount referred to in paragraph (a)(3)(i)(A) of this section shall include amounts previously included in gross income by the company pursuant to such mark to market election with respect to such stock for prior taxable years. For further guidance, see Notice 92–53 (1992–2 C.B. 384) (*see* also 601.601(d)(2) of this chapter).

(b) *Application of section 1296 election*—(1) *In general.* Any United States person and any controlled foreign corporation (CFC) that owns directly, or is treated as owning under this section, marketable stock, as defined in § 1.1296–2, in a PFIC may make an election to mark to market such stock in accordance with the provisions of section 1296 and this section.

(2) *Election applicable to specific United States person.* A section 1296 election applies only to the United States person (or CFC that is treated as a U.S. person under paragraph (g)(2) of this section) that makes the election. Accordingly, a United States person's section 1296 election will not apply to a transferee of section 1296 stock.

(3) *Election applicable to specific corporation only.* A section 1296 election is made with respect to a single foreign corporation, and thus a separate section 1296 election must be made for each foreign corporation that otherwise meets the requirements of this section. A United States person's section 1296 election with respect to stock in a foreign corporation applies to all marketable stock of the corporation that the person owns directly, or is treated as owning under paragraph (e) of this section, at the time of the election or that is subsequently acquired.

(c) *Effect of election*—(1) *Recognition of gain.* If the fair market value of section 1296 stock on the last day of the United States person's taxable year exceeds its adjusted basis, the United States person shall include in gross income for

its taxable year the excess of the fair market value of such stock over its adjusted basis (mark to market gain).

(2) *Character of gain*. Mark to market gain, and any gain on the sale or other disposition of section 1296 stock, shall be treated as ordinary income.

(3) *Recognition of loss*. If the adjusted basis of section 1296 stock exceeds its fair market value on the last day of the United States person's taxable year, such person shall be allowed a deduction for such taxable year equal to the lesser of the amount of such excess or the unreversed inclusions with respect to such stock (mark to market loss).

(4) *Character of loss*—(i) *Losses not in excess of unreversed inclusions*. Any mark to market loss allowed as a deduction under paragraph (c)(3) of this section, and any loss on the sale or other disposition of section 1296 stock, to the extent that such loss does not exceed the unreversed inclusions attributable to such stock, shall be treated as an ordinary loss, deductible in computing adjusted gross income.

(ii) *Losses in excess of unreversed inclusions*. Any loss recognized on the sale or other disposition of section 1296 stock in excess of any prior unreversed inclusions will be subject to the rules generally applicable to losses provided elsewhere in the Internal Revenue Code and the regulations thereunder.

(5) *Application of election to separate lots of stock*. In the case in which a United States person purchased or acquired shares of stock in a PFIC at different prices, the rules of this section shall be applied in a manner consistent with the rules of § 1.1012–1.

(6) *Source rules*. The source of any amount included in gross income under paragraph (c)(1) of this section, or the allocation and apportionment of any amount allowed as a deduction under paragraph (c)(3) of this section, shall be determined in the same manner as if such amounts were gain or loss (as the case may be) from the sale of stock in the PFIC.

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

Example 1. Treatment of gain as ordinary income. A, a United States individual, purchases stock in FX, a foreign corporation that is not a PFIC, in 1990 for $1,000. On January 1, 2005, when the fair market value of the FX stock is $1,100, FX becomes a PFIC. A makes a timely section 1296 election for taxable year 2005. On December 31, 2005, the fair market value of the FX stock is $1,200. For taxable year 2005, A includes $200 of mark to market gain (the excess of the fair market value of FX stock ($1,200) over A's adjusted basis ($1,000)) in gross income as ordinary income and pursuant to paragraph (d)(1) of this section increases his basis in the FX stock by that amount.

Example 2. Treatment of gain as capital gain. The facts are the same as in *Example 1.* For taxable year 2006, FX does not satisfy either the asset test or the income test of section 1297(a). A does not revoke the section 1296 election it made with respect to the FX stock. On December 1, 2006, A sells the FX stock when the fair market value of the stock is $1,500. For taxable year 2006, A includes $300 of gain (the excess of the fair market value of FX stock ($1,500) over A's adjusted basis ($1,200)) in gross income as long-term capital gain because at the time of sale of the FX stock by A, FX did not qualify as a PFIC, and, therefore, the FX stock was not section 1296 stock at the time of the disposition. Further, A's holding period for non-PFIC purposes was more than one year.

Example 3. Treatment of losses as ordinary where they do not exceed unreversed inclusions. The facts are the same as in *Example 1.* On December 1, 2006, A sells the stock in FX for $1,100. At that time, A's unreversed inclusions (the amount A included in income as mark to market gain) with respect to the stock in FX are $200. Accordingly, for taxable year 2006, A recognizes a loss on the sale of the FX stock of $100, (the fair market value of the FX stock ($1,100) minus A's adjusted basis ($1,200) in the stock) that is treated as an ordinary loss because the loss does not exceed the unreversed inclusions attributable to the stock of FX.

Example 4. Treatment of losses as long-term capital losses. The facts are the same as in *Example 3,* except that FX does not satisfy either the asset test or the income test of section 1297(a) for taxable year 2006. For taxable year 2006, A's $100 loss from the sale of the FX stock is treated as long-term capital loss because at the time of the sale of the FX stock by A FX did not qualify as a PFIC, and, therefore, the FX stock was not section 1296 stock at the time of the disposition. Further, A's holding period in the FX stock for non-PFIC purposes was more than one year.

Example 5. Long-term capital loss treatment of losses in excess of unreversed inclusions. The facts are the same as in *Example 3,* except that A sells his FX stock for $900. At the time of A's sale of the FX stock on December 1, 2006, A's unreversed inclusions with respect to the FX stock are $200. Accordingly,

the $300 loss recognized by A on the disposition is treated as an ordinary loss to the extent of his unreversed inclusions ($200). The amount of the loss in excess of A's unreversed inclusions ($100) will be treated as a long-term capital loss because A's holding period in the FC stock for non-PFIC purposes was more than one year.

Example 6. Application of section 1296 election to separate lots of stock. On January 1, 2005, Corp A, a domestic corporation, purchased 100 shares (first lot) of stock in FX, a PFIC, for $500 ($5 per share). On June 1, 2005, Corp A purchased 100 shares (second lot) of FX stock for $1,000 ($10 per share). Corp A made a timely section 1296 election with respect to its FX stock for taxable year 2005. On December 31, 2005, the fair market value of FX stock was $8 per share. For taxable year 2005, Corp A includes $300 of gain in gross income as ordinary income under paragraph (c)(1) of this section with respect to the first lot, and adjusts its basis in that lot to $800 pursuant to paragraph (d)(1) of this section. With respect to the second lot, Corp A is not permitted to recognize a loss under paragraph (c)(3) of this section for taxable year 2005. Although Corp A's adjusted basis in that stock exceeds its fair market value by $200, Corp A has no unreversed inclusions with respect to that particular lot of stock. On July 1, 2006, Corp A sells 100 shares of FX stock for $900. Assuming that Corp A adequately identifies (in accordance with the rules of § 1.1012–1(c)) the shares of FX stock sold as being from the second lot, Corp A recognizes $100 of long term capital loss pursuant to paragraph (c)(4)(ii) of this section.

(d) *Adjustment to basis*—(1) *Stock held directly.* The adjusted basis of the section 1296 stock shall be increased by the amount included in the gross income of the United States person under paragraph (c)(1) of this section with respect to such stock, and decreased by the amount allowed as a deduction to the United States person under paragraph (c)(3) of this section with respect to such stock.

(2) *Stock owned through certain foreign entities.* (i) In the case of section 1296 stock that a United States person is treated as owning through certain foreign entities pursuant to paragraph (e) of this section, the basis adjustments under paragraph (d)(1) of this section shall apply to such stock in the hands of the foreign entity actually holding such stock, but only for purposes of determining the subsequent treatment under chapter 1 of the Internal Revenue Code of the United States person with respect to such stock. Such increase or decrease in the adjusted basis of the section 1296 stock shall constitute an adjustment to the basis of partnership property only with respect to the partner making the section 1296 election. Corresponding adjustments shall be made to the adjusted basis of the United States person's interest in the foreign entity and in any intermediary entity described in paragraph (e) of this section through which the United States person holds the PFIC stock.

(ii) *Example.* The following example illustrates this paragraph (d)(2):

Example. FP is a foreign partnership. Corp A, a domestic corporation, owns a 20 percent interest in FP. Corp B, a domestic corporation, owns a 30 percent interest in FP. Corp C, a foreign corporation, with no direct or indirect shareholders that are U.S. persons, owns a 50% interest in FP. Corp A, Corp B, and FP all use a calendar year for their taxable year. In 2005, FP purchases stock in FX, a foreign corporation and a PFIC, for $1,000. Corp A makes a timely section 1296 election for taxable year 2005. On December 31, 2005, the fair market value of the PFIC stock is $1,100. Corp A includes $20 of ordinary income in taxable year 2005 under paragraphs (c)(1) and (2) of this section. Corp A increases its basis in its FP partnership interest by $20. FP increases its basis in the FX stock to $1,020 solely for purposes of determining the subsequent treatment of Corp A, under chapter 1 of the Internal Revenue Code, with respect to such stock. In 2006, FP sells the FX stock for $1,200. For purposes of determining the amount of gain of Corp A, FP will be treated as having $180 in gain of which $20 is allocated to Corp A. Corp A's $20 of gain will be treated as ordinary income under paragraph (c)(2) of this section. For purposes of determining the amount of gain attributable to Corp B, FP will be treated as having $200 gain, $60 of which will be allocated to Corp B.

(3) *Stock owned indirectly by an eligible RIC.* Paragraph (d)(2) of this section shall also apply to an eligible RIC which is an indirect shareholder under § 1.1296–2(f) of stock in a PFIC and has a valid section 1296 election in effect with respect to the PFIC stock.

(4) *Stock acquired from a decedent.* In the case of stock of a PFIC that is acquired by bequest, devise, or inheritance (or by the decedent's estate) and with respect to which a section 1296 election was in effect as of the date of the decedent's death, notwithstanding section 1014 or section 1022, the basis of such stock in the hands of the person

so acquiring it shall be the adjusted basis of such stock in the hands of the decedent immediately before his death (or, if lesser, the basis that would have been determined under section 1014 or section 1022 without regard to this paragraph (d)).

(5) *Transition rule for individuals becoming subject to United States income taxation*—(i) *In general.* If any individual becomes a United States person in a taxable year beginning after December 31, 1997, solely for purposes of this section, the adjusted basis, before adjustments under this paragraph (d), of any section 1296 stock owned by such individual on the first day of such taxable year shall be treated as being the greater of its fair market value or its adjusted basis on such first day.

(ii) An example of the transition rule for individuals becoming subject to United States income taxation is as follows:

Example. A, a nonresident alien individual, purchases marketable stock in FX, a PFIC, for $50 in 1995. On January 1, 2005, A becomes a United States person and makes a timely section 1296 election with respect to the stock in accordance with paragraph (h) of this section. The fair market value of the FX stock on January 1, 2005, is $100. The fair market value of the FX stock on December 31, 2005, is $110. Under paragraph (d)(5)(i) of this section, A computes the amount of mark to market gain or loss for the FX stock in 2005 by reference to an adjusted basis of $100, and therefore A includes $10 in gross income as mark to market gain under paragraph (c)(1) of this section. Additionally, under paragraph (d)(1) of this section, A's adjusted basis in the FX stock for purposes of this section is increased to $110 (and to $60 for all other tax purposes). A sells the FX stock in 2006 for $120. For purposes of applying section 1001, A must use its original basis of $50, with any adjustments under paragraph (d)(1) of this section, $10 in this case, and therefore A recognizes $60 of gain. Under paragraph (c)(2) of this section (which is applied using an adjusted basis of $110), $10 of such gain is treated as ordinary income. The remaining $50 of gain from the sale of the FX stock is long term capital gain because A held such stock for more than one year.

(e) *Stock owned through certain foreign entities*—(1) *In general.* Except as provided in paragraph (e)(2) of this section, the following rules shall apply in determining stock ownership for purposes of this section. PFIC stock owned, directly or indirectly, by or for a foreign partnership, foreign trust (other than a foreign trust described in sections 671 through 679), or foreign estate shall be considered as being owned proportionately by its partners or beneficiaries. PFIC stock owned, directly or indirectly, by or for a foreign trust described in sections 671 through 679 shall be considered as being owned proportionately by its grantors or other persons treated as owners under sections 671 through 679 of any portion of the trust that includes the stock. The determination of a person's proportionate interest in a foreign partnership, foreign trust or foreign estate will be made on the basis of all the facts and circumstances. Stock considered owned by reason of this paragraph shall, for purposes of applying the rules of this section, be treated as actually owned by such person.

(2) *Stock owned indirectly by eligible RICs.* The rules for attributing ownership of stock contained in § 1.1296–2(f) will apply to determine the indirect ownership of PFIC stock by an eligible RIC.

(f) *Holding period.* Solely for purposes of sections 1291 through 1298, if section 1296 applied to stock with respect to the taxpayer for any prior taxable year, the taxpayer's holding period in such stock shall be treated as beginning on the first day of the first taxable year beginning after the last taxable year for which section 1296 so applied.

(g) *Special rules*—(1) *Certain dispositions of stock.* To the extent a United States person is treated as actually owning stock in a PFIC under paragraph (e) of this section, any disposition which results in the United States person being treated as no longer owning such stock, and any disposition by the person owning such stock, shall be treated as a disposition by the United States person of the stock in the PFIC.

(2) *Treatment of CFC as a United States person.* In the case of a CFC that owns, or is treated as owning under paragraph (e) of this section, section 1296 stock:

(i) Other than with respect to the sourcing rules in paragraph (c)(6) of this section, this section shall apply to the CFC in the same manner as if such

corporation were a United States person. The CFC will be treated as a foreign person for purposes of applying the source rules of paragraph (c)(6).

(ii) For purposes of subpart F of part III of subchapter N of the Internal Revenue Code—

(A) Amounts included in the CFC's gross income under paragraph (c)(1) or (i)(2)(ii) of this section shall be treated as foreign personal holding company income under section 954(c)(1)(A); and

(B) Amounts allowed as a deduction under paragraph (c)(3) of this section shall be treated as a deduction allocable to foreign personal holding company income for purposes of computing net foreign base company income under § 1.954–1(c).

(iii) A United States shareholder, as defined in section 951(b), of the CFC shall not be subject to section 1291 with respect to any stock of the PFIC for the period during which the section 1296 election is in effect for that stock, and the holding period rule of paragraph (f) of this section shall apply to such United States shareholder.

(iv) The rules of this paragraph (g)(2) shall not apply to a United States person that is a shareholder of the PFIC for purposes of section 1291, but is not a United States shareholder under section 951(b) with respect to the CFC making a section 1296 election.

(3) *Timing of inclusions for stock owned through certain foreign entities.* In the case of section 1296 stock that a United States person is treated as owning through certain foreign entities pursuant to paragraph (e) of this section, the mark to market gain or mark to market loss is determined in accordance with paragraphs (c) and (i)(2)(ii) of this section as of the last day of the taxable year of the foreign partnership, foreign trust or foreign estate and then included in the taxable year of such United States person that includes the last day of the taxable year of the entity.

(h) *Elections*—(1) *Timing and manner for making a section 1296 election*—(i) *United States persons.* A United States person that owns marketable stock in a PFIC, or is treated as owning marketable stock under paragraph (e) of this section, on the last day of the taxable year of such person, and that wants to make a section 1296 election, must make a section 1296 election for such taxable year on or before the due date (including extensions) of the United States person's income tax return for that year. The section 1296 election must be made on the Form 8621, ''Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund'', included with the original tax return of the United States person for that year, or on an amended return, provided that the amended return is filed on or before the election due date.

(ii) *Controlled foreign corporations.* A section 1296 election by a CFC shall be made by its controlling United States shareholders, as defined in § 1.964–1(c)(5), and shall be included with the Form 5471, ''Information Return of U.S. Persons With Respect to Certain Foreign Corporations'', for that CFC by the due date (including extensions) of the original income tax returns of the controlling United States shareholders for that year. A section 1296 election by a CFC shall be binding on all United States shareholders of the CFC.

(iii) *Retroactive elections for PFIC stock held in prior years.* A late section 1296 election may be permitted only in accordance with § 301.9100 of this chapter.

(2) *Effect of section 1296 election*—(i) A section 1296 election will apply to the taxable year for which such election is made and remain in effect for each succeeding taxable year unless such election is revoked or terminated pursuant to paragraph (h)(3) of this section.

(ii) *Cessation of a foreign corporation as a PFIC.* A United States person will not include mark to market gain or loss pursuant to paragraph (c) of this section with respect to any stock of a foreign corporation for any taxable year that such foreign corporation is not a PFIC under section 1297 or treated as a PFIC under section 1298(b)(1) (taking into account the holding period rule of paragraph (f) of this section). Cessation of a foreign corporation's status as a PFIC will not, however, terminate a section 1296 election. Thus, if a foreign corporation is a PFIC in a taxable year after a year in which it is not treated as a PFIC, the United

States person's original election (unless revoked or terminated in accordance with paragraph (h)(3) of this section) continues to apply and the shareholder must include any mark to market gain or loss in such year.

(3) *Revocation or termination of election*—(i) *In general.* A United States person's section 1296 election is terminated if the section 1296 stock ceases to be marketable; if the United States person elects, or is required, to mark to market the section 1296 stock under another provision of chapter 1 of the Internal Revenue Code; or if the Commissioner, in the Commissioner's discretion, consents to the United States person's request to revoke its section 1296 election upon a finding of a substantial change in circumstances. A substantial change in circumstances for this purpose may include a foreign corporation ceasing to be a PFIC.

(ii) *Timing of termination or revocation.* Where a section 1296 election is terminated automatically (*e.g.*, the stock ceases to be marketable), section 1296 will cease to apply beginning with the taxable year in which such termination occurs. Where a section 1296 election is revoked with the consent of the Commissioner, section 1296 will cease to apply beginning with the first taxable year of the United States person after the revocation is granted unless otherwise provided by the Commissioner.

(4) *Examples.* The operation of the rules of this paragraph (h) is illustrated by the following examples:

Example 1. A, a United States person, owns stock in FX, a PFIC. A makes a QEF election in 1996 with respect to the FX stock. For taxable year 2005, A makes a timely section 1296 election with respect to its stock, and thus its QEF election is automatically terminated pursuant to §1.1295–1(i)(3). In 2006, A's stock in FX ceases to be marketable, and therefore its section 1296 election is automatically terminated under paragraph (h)(3) of this section. Beginning with taxable year 2006, A is subject to the rules of section 1291 with respect to its FX stock unless it makes a new QEF election. See §1.1295–1(i)(5).

Example 2. The facts are the same as in *Example 1,* except that A's stock in FX becomes marketable again in 2007. A may make a new section 1296 election with respect to the FX stock for its taxable year 2007, or thereafter. A will be subject to the coordination rules under paragraph (i) of this section unless it made a new QEF election in 2006.

(i) *Coordination rules for first year of election*—(1) *In general.* Notwithstanding any provision in this section to the contrary, the rules of this paragraph (i) shall apply to the first taxable year in which a section 1296 election is effective with respect to marketable stock of a PFIC if such foreign corporation was a PFIC for any taxable year, prior to such first taxable year, during the United States person's holding period (as defined in paragraph (f) of this section) in such stock, and for which such corporation was not treated as a QEF with respect to such United States person.

(2) *Shareholders other than regulated investment companies.* For the first taxable year of a United States person (other than a regulated investment company) for which a section 1296 election is in effect with respect to the stock of a PFIC, such United States person shall, in lieu of the rules of paragraphs (c) and (d) of this section—

(i) Apply the rules of section 1291 to any distributions with respect to, or disposition of, section 1296 stock;

(ii) Apply section 1291 to the amount of the excess, if any, of the fair market value of such section 1296 stock on the last day of the United States person's taxable year over its adjusted basis, as if such amount were gain recognized from the disposition of stock on the last day of the taxpayer's taxable year; and

(iii) Increase its adjusted basis in the section 1296 stock by the amount of excess, if any, subject to section 1291 under paragraph (i)(2)(ii) of this section.

(3) *Shareholders that are regulated investment companies.* For the first taxable year of a regulated investment company for which a section 1296 election is in effect with respect to the stock of a PFIC, such regulated investment company shall increase its tax under section 852 by the amount of interest that would have been imposed under section 1291(c)(3) for such taxable year if such regulated investment company were subject to the rules of paragraph (i)(2) of this section, and not this paragraph (i)(3). No deduction or increase in basis shall be allowed for the increase in tax imposed under this paragraph (i)(3).

(4) The operation of the rules of this paragraph (i) is illustrated by the following examples:

Example (1). A, a United States person and a calendar year taxpayer, owns marketable stock in FX, a PFIC that it acquired on January 1, 1992. At all times, A's FX stock was a nonqualified fund subject to taxation under section 1291. A made a timely section 1296 election effective for taxable year 2005. At the close of taxable year 2005, the fair market value of A's FX stock exceeded its adjusted basis by $10. Pursuant to paragraph (i)(2)(ii) of this section, A must treat the $10 gain under section 1291 as if the FX stock were disposed of on December 31, 2005. Further, A increases its adjusted basis in the FX stock by the $10 in accordance with paragraph (i)(2)(iii) of this section.

Example (2). Assume the same facts as in *Example (1)*, except that A is a RIC that had not made an election prior to 2005 to mark to market the PFIC stock. In taxable year 2005, A includes $10 of ordinary income under paragraph (c)(1) of this section, and such amount is not subject to section 1291. A also increases its tax imposed under section 852 by the amount of interest that would have been determined under section 1291(c)(3), and no deduction is permitted for such amount. Finally, under paragraph (d)(1) of this section, A increases its adjusted basis in the FX stock by $10.

(j) *Effective/applicability date.* The provisions in this section are applicable for taxable years beginning on or after May 3, 2004. The provisions of paragraph (d)(4) of this section relating to section 1022 are effective on and after January 19, 2017.

[T.D. 9123, 69 FR 24074, May 3, 2004, as amended by T.D. 9811, 82 FR 6242, Jan. 19, 2017]

§ 1.1296–2 Definition of marketable stock.

(a) *General rule.* For purposes of section 1296, the term *marketable stock* means—

(1) Passive foreign investment company (PFIC) stock that is regularly traded, as defined in paragraph (b) of this section, on a qualified exchange or other market, as defined in paragraph (c) of this section;

(2) Stock in certain PFICs, as described in paragraph (d) of this section; and

(3) Options on stock that is described in paragraph (a)(1) or (2) of this section, to the extent provided in paragraph (e) of this section.

(b) *Regularly traded*—(1) *General rule.* For purposes of paragraph (a)(1) of this section, a class of stock that is traded on one or more qualified exchanges or other markets, as defined in paragraph (c) of this section, is regularly traded on such exchanges or markets for any calendar year during which such class of stock is traded, other than in de minimis quantities, on at least 15 days during each calendar quarter.

(2) *Special rule for year of initial public offering.* For the calendar year in which a corporation initiates a public offering of a class of stock for trading on one or more qualified exchanges or other markets, as defined in paragraph (c) of this section, such class of stock meets the requirements of paragraph (b)(1) of this section for such year if the stock is regularly traded on such exchanges or markets, other than in de minimis quantities, on ⅙ of the days remaining in the quarter in which the offering occurs, and on at least 15 days during each remaining quarter of the taxpayer's calendar year. In cases where a corporation initiates a public offering of a class of stock in the fourth quarter of the calendar year, such class of stock meets the requirements of paragraph (b)(1) of this section in the calendar year of the offering if the stock is regularly traded on such exchanges or markets, other than in de minimis quantities, on the greater of ⅙ of the days remaining in the quarter in which the offering occurs, or 5 days.

(3) *Anti-abuse rule.* Trades that have as one of their principal purposes the meeting of the trading requirements of paragraph (b)(1) or (2) of this section shall be disregarded. Further, a class of stock shall not be treated as meeting the trading requirement of paragraph (b)(1) or (2) of this section if there is a pattern of trades conducted to meet the requirement of paragraph (b)(1) or (2) of this section. Similarly, paragraph (b)(2) of this section shall not apply to a public offering of stock that has as one of its principal purposes to avail itself of the reduced trading requirements under the special rule for the calendar year of an initial public offering. For purposes of applying the immediately preceding sentence, consideration will be given to whether the

trading requirements of paragraph (b)(1) of this section are satisfied in the subsequent calendar year.

(c) *Qualified exchange or other market*—(1) *General rule*. For purposes of paragraph (a)(1) of this section, the term *qualified exchange or other market* means, for any calendar year—

(i) A national securities exchange that is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities Exchange Act of 1934 (15 U.S.C. 78f); or

(ii) A foreign securities exchange that is regulated or supervised by a governmental authority of the country in which the market is located and which has the following characteristics—

(A) The exchange has trading volume, listing, financial disclosure, surveillance, and other requirements designed to prevent fraudulent and manipulative acts and practices, to remove impediments to and perfect the mechanism of a free and open, fair and orderly, market, and to protect investors; and the laws of the country in which the exchange is located and the rules of the exchange ensure that such requirements are actually enforced; and

(B) The rules of the exchange effectively promote active trading of listed stocks.

(2) *Exchange with multiple tiers*. If an exchange in a foreign country has more than one tier or market level on which stock may be separately listed or traded, each such tier shall be treated as a separate exchange.

(d) *Stock in certain PFICs*—(1) *General rule*. Except as provided in paragraph (d)(2) of this section, a foreign corporation is a corporation described in section 1296(e)(1)(B), and paragraph (a)(2) of this section, if the foreign corporation offers for sale or has outstanding stock of which it is the issuer and which is redeemable at its net asset value and if the foreign corporation satisfies the following conditions with respect to the class of shares held by the electing taxpayer—

(i) At all times during the calendar year, the foreign corporation has more than one hundred shareholders with respect to the class, other than shareholders who are related under section 267(b);

(ii) At all times during the calendar year, the class of shares of the foreign corporation is readily available for purchase by the general public at its net asset value and the foreign corporation does not require a minimum initial investment of greater than $10,000 (U.S.);

(iii) At all times during the calendar year, quotations for the class of shares of the foreign corporation are determined and published no less frequently than on a weekly basis in a widely-available permanent medium not controlled by the issuer of the shares, such as a newspaper of general circulation or a trade publication;

(iv) No less frequently than annually, independent auditors prepare financial statements of the foreign corporation that include balance sheets (statements of assets, liabilities, and net assets) and statements of income and expenses, and those statements are made available to the public;

(v) The foreign corporation is supervised or regulated as an investment company by a foreign government or an agency or instrumentality thereof that has broad inspection and enforcement authority and effective oversight over investment companies;

(vi) At all times during the calendar year, the foreign corporation has no senior securities authorized or outstanding, including any debt other than in de minimis amounts;

(vii) Ninety percent or more of the gross income of the foreign corporation for its taxable year is passive income, as defined in section 1297(a)(1) and the regulations thereunder; and

(viii) The average percentage of assets held by the foreign corporation during its taxable year which produce passive income or which are held for the production of passive income, as defined in section 1297(a)(2) and the regulations thereunder, is at least 90 percent.

(2) *Anti-abuse rule*. If a foreign corporation undertakes any actions that have as one of their principal purposes the manipulation of the net asset value of a class of its shares, for the calendar year in which the manipulation occurs, the shares are not marketable stock

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(e) [Reserved]

(f) *Special rules for regulated investment companies (RICs)*—(1) *General rule.* In the case of any RIC that is offering for sale, or has outstanding, any stock of which it is the issuer and which is redeemable at net asset value, if the RIC owns directly or indirectly, as defined in section 1298(a), stock in any passive foreign investment company, that stock will be treated as marketable stock owned by that RIC for purposes of section 1296. Except as provided in paragraph (f)(2) of this section, in the case of any other RIC that publishes net asset valuations at least annually, if the RIC owns directly or indirectly, as defined in section 1298(a), stock in any passive foreign investment company, that stock will be treated as marketable stock owned by that RIC for purposes of section 1296.

(2) [Reserved]

(g) *Effective date.* This section applies to shareholders whose taxable year ends on or after January 25, 2000 for stock in a foreign corporation whose taxable year ends with or within the shareholder's taxable year. In addition, shareholders may elect to apply these regulations to any taxable year beginning after December 31, 1997, for stock in a foreign corporation whose taxable year ends with or within the shareholder's taxable year.

[T.D. 8867, 65 FR 3819, Jan. 25, 2000. Redesignated and amended by T.D. 9123, 69 FR 24073, May 3, 2004]

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This section contains a listing of the headings for §§ 1.1297–1, 1.1297–2, 1.1297–3, 1.1297–4, 1.1297–5, and 1.1297–6.

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[T.D. 9360, 72 FR 54821, Sept. 27, 2007, as amended by T.D. 9936, 86 FR 4556, Jan. 15, 2021; T.D. 9936, 86 FR 13648, Mar. 10, 2021]

§ 1.1297–1 Definition of passive foreign investment company.

(a) *Overview*. This section provides rules concerning the income test set forth in section 1297(a)(1) and the asset test set forth in section 1297(a)(2). Paragraph (b) of this section provides a rule relating to the definition of gross income with respect to certain dividends that are excluded from gross income under section 1502 for purposes of section 1297. Paragraph (c) of this section provides rules relating to the definition of passive income for purposes of section 1297. Paragraph (d) of this section provides rules relating to the asset test of section 1297. See §§ 1.1297–2 and 1.1297–6 for additional rules concerning the treatment of the income and assets of a corporation subject to look-through treatment under section 1297(c). Paragraph (e) of this section provides rules relating to the determination of passive foreign investment company (PFIC) status for stapled entities. Paragraph (f) of this section provides definitions applicable for this section, and paragraph (g) of this section provides the applicability date of this section.

(b) *Dividends included in gross income*—(1) *General rule*. For purposes of section 1297, gross income includes dividends that are excluded from gross income under section 1502 and § 1.1502–13.

(2) *Example*—(i) *Facts*. USP is a domestic corporation that owns 30% of TFC, a foreign corporation. The remaining 70% of TFC is owned by FP, a foreign corporation that is unrelated to USP. TFC owns 25% of the value of USS1, a domestic corporation. USS1 owns 80% of the value of USS2, a domestic corporation. USS1 and USS2 are members of an affiliated group (as defined in section 1504(a)) filing a consolidated return. USS2 distributes a dividend to USS1 that is excluded from USS1's income pursuant to § 1.1502–13 for purposes of determining the U.S. Federal income tax liability of the affiliated group of which USS1 and USS2 are members.

(ii) *Results*. Although the dividend received by USS1 from USS2 is excluded from USS1's income for purposes of determining the U.S. Federal income tax liability of the affiliated group of which USS1 and USS2 are members, pursuant to paragraph (b)(1) of this section, for purposes of section 1297, USS1's gross income includes the USS2 dividend. Accordingly, for purposes of section 1297, TFC's gross income includes 25% of the dividend received by USS1 from USS2 pursuant to section 1297(c) and § 1.1297–2(b)(2)(ii). See section 1298(b)(7) and § 1.1298–4 for rules

concerning the characterization of the USS2 dividend.

(c) *Passive income*—(1) *Foreign personal holding company income*—(i) *General rule*. For purposes of section 1297(b)(1), except as otherwise provided in section 1297(b)(2), this section, and § 1.1297–6, the term *passive income* means income of a kind that would be foreign personal holding company income as defined under section 954(c). For the purpose of this paragraph (c)(1)—

(A) The exceptions to foreign personal holding company income in section 954(c)(1), 954(c)(2)(A) (relating to active rents and royalties), 954(c)(2)(B) (relating to export financing income), and 954(c)(2)(C) (relating to dealers) are taken into account;

(B) The exceptions in section 954(c)(3) (relating to certain income received from related persons), 954(c)(6) (relating to certain amounts received from related controlled foreign corporations), and 954(i) (relating to entities engaged in the active conduct of an insurance business) are not taken into account;

(C) The rules in section 954(c)(4) (relating to sales of certain partnership interests) and 954(c)(5) (relating to certain commodity hedging transactions) are taken into account; and

(D) An entity is treated as a controlled foreign corporation within the meaning of section 957(a) for purposes of applying an exception to foreign personal holding company income in section 954(c)(1)(B)'s flush language, (1)(C)(ii), (1)(D), (4), and (5) and § 1.954–2 and for purposes of identifying whether a person is a related person with respect to such entity within the meaning of section 954(d)(3).

(ii) *Determination of gross income or gain on a net basis for certain items of foreign personal holding company income*. For purposes of section 1297, the excess of gains over losses from property transactions described in section 954(c)(1)(B), the excess of gains over losses from transactions in commodities described in section 954(c)(1)(C), the excess of foreign currency gains over foreign currency losses described in section 954(c)(1)(D), and positive net income from notional principal contracts described in section 954(c)(1)(F) are taken into account as gross income. The excess of gains over losses (or, with respect to notional principal contracts, positive net income) for a category of transactions is calculated by a tested foreign corporation taking into account individual items of gain or loss (or, with respect to notional principal contracts, net income or net deduction) recognized by the tested foreign corporation and those items of gain or loss (or, with respect to notional principal contracts, net income or net deduction) treated as recognized by the tested foreign corporation with respect to its look-through subsidiaries and look-through partnerships pursuant to section 1297(c) and § 1.1297–2(b)(2) or (3).

(iii) *Amounts treated as dividends*. For purposes of section 1297, the term dividend includes all amounts treated as dividends for purposes of this chapter, including amounts treated as dividends pursuant to sections 302, 304, 356(a)(2), 964(e), and 1248.

(2) [Reserved]

(3) *Passive treatment of dividends and distributive share of partnership income*. For purposes of section 1297, a tested foreign corporation's share of dividends received from a corporation that is not a look-through subsidiary (as defined in § 1.1297–2(g)(3)) and distributive share of any item of income of a partnership that is not a look-through partnership (as defined in § 1.1297–2(g)(4)) with respect to a tested foreign corporation are treated as passive income, except to the extent that the item of income would not be treated as passive under section 1297(b)(2)(C) and paragraph (c)(4) of this section.

(4) *Exception for certain interest, dividends, rents, and royalties received from a related person*—(i) *In general*. For purposes of section 1297(b)(2)(C), interest, dividends, rents, or royalties actually received or accrued by a tested foreign corporation are considered received or accrued from a related person only if the payor of the interest, dividend, rent, or royalty is a related person (within the meaning of section 954(d)(3)) with respect to the tested foreign corporation, taking into account paragraph (c)(1)(i)(D) of this section. For rules determining when amounts received or accrued by a look-through subsidiary or look-through partnership

(and treated as received directly by a tested foreign corporation pursuant to section 1297(c) and § 1.1297–2(b)(2) and (b)(3)) are treated as received from a related person, see § 1.1297–2(d).

(ii) *Ordering rule.* Gross income that is interest, a dividend, or a rent or royalty that is, in each case, received or accrued from a related person is allocated to income that is not passive under the rules of this paragraph (c)(4). If the related person is also a look-through subsidiary or a look-through partnership with respect to the tested foreign corporation, this paragraph (c)(4) applies after the application of the intercompany income rules of § 1.1297–2(c).

(iii) *Allocation of interest.* For purposes of section 1297(b)(2)(C), interest that is received or accrued, as applicable based on the recipient's method of accounting, from a related person is allocated to income of the related person that is not passive income in proportion to the ratio of the portion of the related person's non-passive gross income for its taxable year that ends with or within the taxable year of the recipient to the total amount of the related person's gross income for the taxable year. If the related person does not have gross income for the taxable year that ends with or within the taxable year of the recipient, the interest is either allocated to income of the related person that is not passive income to the extent the related person's deduction for the interest would be allocable to non-passive income of the related person under the principles of §§ 1.861–9 through 1.861–13T, applied in a reasonable and consistent manner taking into account the general operation of the PFIC rules and the purpose of section 1297(b)(2)(C) or, alternatively, at the election of the tested foreign corporation is treated as allocated entirely to passive income.

(iv) *Allocation of dividends*—(A) *In general.* For purposes of section 1297(b)(2)(C), the principles of § 1.316–2(a) apply in determining from what year's earnings and profits a dividend from a related person is treated as distributed. A dividend is considered to be distributed, first, out of the earnings and profits of the taxable year of the related person that includes the date the dividend is distributed (current earnings and profits) and that ends with or within the taxable year of the recipient; second, out of the earnings and profits accumulated for the immediately preceding taxable year of the related person; third, out of the earnings and profits accumulated for the second preceding taxable year of the related person; and so forth. For purposes of paragraph (c)(4)(iv) of this section, the principles of § 1.243–4(a)(6) apply with respect to a deficit in an earnings and profits account for a prior year.

(B) *Dividends paid out of current earnings and profits.* To the extent that a dividend is paid out of current earnings and profits of the related person for its taxable year that ends with or within the taxable year of the recipient, the dividend is treated as paid ratably out of earnings and profits attributable to passive income and to non-passive income. The portion of the current earnings and profits that is treated as paid out of non-passive income of the related person may be determined by multiplying the current earnings and profits by the ratio of the related person's non-passive gross income as determined under this section (including paragraph (c)(1)(ii) of this section) for the taxable year to its total gross income as determined under this section (including paragraph (c)(1)(ii) of this section) for that year.

(C) *Dividends paid out of accumulated earnings and profits.* To the extent that a dividend from a related person is treated as paid out of the related person's accumulated earnings and profits, the dividend is treated as paid ratably out of accumulated earnings and profits of the related person for prior taxable years (beginning with the most recently accumulated) that are attributable to passive income and to non-passive income, which may be determined in the same manner as in paragraph (c)(4)(iv)(B) of this section. Alternatively, the accumulated earnings and profits may be allocated based on the ratio of accumulated earnings and profits that are attributable to passive income and to non-passive income during either the related party period or the three-year period. The related party period is the entire period during

which the related person was related to the recipient. The three-year period is the three taxable years immediately preceding the related person's taxable year that ends with or within the current taxable year of the recipient. The three-year period may be used only if the related person has been related to the recipient for a period longer than the three taxable years immediately preceding the recipient's taxable year.

(v) *Allocation of rents and royalties.* For purposes of section 1297(b)(2)(C), rents and royalties that are received or accrued, as applicable based on the recipient's method of accounting, from a related person are allocable to income of the related person that is not passive income to the extent the related person's deduction for the rent or royalty is allocable to non-passive gross income of the related person under the principles of §§1.861–8 through 1.861–14T.

(vi) *Determination of whether amounts are received or accrued from a related person.* For purposes of section 1297(b)(2)(C), the determination of whether interest, dividends, rents, and royalties were received or accrued from a related person is made on the date of the receipt or accrual, as applicable based on the recipient's method of accounting, of the interest, dividend, rent, or royalty.

(vii) *Allocation of distributive share of income from related partnership.* For purposes of section 1297(a)(1), a tested foreign corporation includes its distributive share as provided in section 704 of the separate items of passive or non-passive income from a partnership that is a related person (and not a look-through partnership) with respect to the tested foreign corporation for the taxable year of the tested foreign corporation.

(d) *Asset test*—(1) *Calculation of average annual value (or adjusted bases)*—(i) *General rule.* For purposes of section 1297, the calculation of the average percentage of assets held by a tested foreign corporation during its taxable year that produce passive income or that are held for the production of passive income is determined based on the average of the fair market values, or the average of the adjusted bases, as appropriate, of the passive assets and total assets held (including assets treated as held pursuant to section 1297(c) and §1.1297–2(b)(2)(i) and (b)(3)) by the foreign corporation on the last day of each measuring period (*measuring date*) of the foreign corporation's taxable year. The average of the fair market values (or the average of the adjusted bases) of the foreign corporation's passive assets or total assets for the taxable year is equal to the sum of the values (or adjusted bases) of the passive assets or total assets, as applicable, on each measuring date of the foreign corporation's taxable year, divided by the number of measuring dates in the taxable year.

(ii) *Measuring period*—(A) *General rule.* Except as otherwise provided in paragraph (d)(1)(ii)(B) of this section, the measuring periods for a tested foreign corporation are the four quarters that make up the foreign corporation's taxable year.

(B) *Election to use alternative measuring period.* The average percentage of assets held by a tested foreign corporation during its taxable year that produce passive income or that are held for the production of passive income may be calculated using a period that is shorter than a quarter (such as a week or month). The same period must be used to measure the assets of the foreign corporation for the first year (including a short taxable year) that this alternative measuring period is used, and for any and all subsequent years, unless a revocation is made. An election to use an alternative measuring period or a revocation of such an election must be made in accordance with the rules of paragraph (d)(1)(iv) of this section.

(C) *Short taxable year.* For purposes of applying section 1297 to a tested foreign corporation that has a taxable year of less than twelve months (short taxable year), the average values (or adjusted bases) are determined based on the measuring dates of the foreign corporation's taxable year that fall within the short taxable year, and by treating the last day of the short taxable year as a measuring date.

(iii) *Adjusted basis election.* An election under section 1297(e)(2)(B) with respect to an eligible tested foreign corporation or a revocation of such an

election may be made by the tested foreign corporation or alternatively by the owner (as defined in paragraph (d)(1)(iv) of this section). If made by the owner, the election must be made in accordance with the rules of paragraph (d)(1)(iv) of this section.

(iv) *Time and manner of elections and revocations*—(A) *Elections.* An owner (as defined in this paragraph (d)(1)(iv)) of a foreign corporation makes an election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii) of this section for a taxable year in the manner provided in the Instructions to Form 8621 (or successor form), if the owner is required to file a Form 8621 (or successor form) with respect to the foreign corporation for the taxable year of the owner in which or with which the taxable year of the foreign corporation for which the election is made ends. If the owner is not required to file Form 8621 (or successor form) with respect to the foreign corporation for the taxable year, the owner makes such an election by filing a written statement providing for the election and attaching the statement to an original or amended Federal income tax return for the taxable year of the owner in which or with which the taxable year of the foreign corporation for which the election is made ends clearly indicating that such election has been made. An election can be made by an owner only if the owner's taxable year for which the election is made, and all taxable years that are affected by the election, are not closed by the period of limitations on assessments under section 6501. Elections described in paragraphs (d)(1)(ii)(B) and (d)(1)(iii) of this section are not eligible for relief under § 301.9100–3 of this chapter. For purposes of this paragraph (d)(1)(iv), an owner of a foreign corporation is a United States person that is eligible under § 1.1295–1(d) to make a section 1295 election with respect to the foreign corporation, or would be eligible under § 1.1295–1(d) to make a section 1295 election if the foreign corporation were a PFIC.

(B) *Revocations and subsequent elections.* An election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii) of this section made pursuant to paragraph (d)(1)(iv)(A) of this section is effective for the taxable year of the foreign corporation for which it is made and all subsequent taxable years of such corporation unless revoked by the Commissioner or the owner (as defined in paragraph (d)(1)(iv)(A) of this section) of the foreign corporation. The owner of a foreign corporation may revoke such an election at any time. If an election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii) of this section has been revoked under this paragraph (d)(1)(iv)(B), a new election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii) of this section, as applicable, cannot be made until the sixth taxable year following the year for which the previous election was revoked, and such subsequent election cannot be revoked until the sixth taxable year following the year for which the subsequent election was made. The owner revokes the election for a taxable year in the manner provided in the Instructions to Form 8621 (or successor form), if the owner is required to file a Form 8621 (or successor form) with respect to the foreign corporation for the taxable year of the owner in which or with which the taxable year of the foreign corporation for which the election is revoked ends, or by filing a written statement providing for the revocation and attaching the statement to an original or amended Federal income tax return for the taxable year of the owner in which or with which the taxable year of the foreign corporation for which the election is revoked ends clearly indicating that such election has been revoked, if the owner is not required to file Form 8621 (or successor form) with respect to the foreign corporation for the taxable year.

(v) *Method of measuring assets*—(A) *Publicly traded foreign corporations.* For purposes of section 1297, the assets of a publicly traded foreign corporation as defined in paragraph (f)(7) of this section (including assets treated as held pursuant to section 1297(c) and § 1.1297–2(b)(2)(i) and (b)(3)(i), other than assets of a look-through subsidiary described in paragraph (d)(1)(v)(B) of this section) must be measured for all measuring periods of the taxable year on the basis of value.

(B) *Non-publicly traded controlled foreign corporation*—(*1*) *In general.* For purposes of section 1297, the assets of a

controlled foreign corporation that is not described in paragraph (d)(1)(v)(A) of this section (including assets treated as held pursuant to section 1297(c) and §1.1297–2(b)(2)(i) and (b)(3)(i), other than assets held by a look-through subsidiary described in paragraph (d)(1)(v)(A) of this section) must be measured for all measuring periods of the taxable year during which the foreign corporation is a controlled foreign corporation on the basis of adjusted basis.

(*2*) *Controlled foreign corporation determination*. For purposes of section 1297(e)(2)(A) and this paragraph (d)(1)(v), the term *controlled foreign corporation* has the meaning provided in section 957, determined without applying subparagraphs (A), (B), and (C) of section 318(a)(3) so as to consider a United States person as owning stock which is owned by a person who is not a United States person.

(C) *Other foreign corporations*—(*1*) *In general*. Except as provided in paragraph (d)(1)(v)(C)(*2*) of this section, the assets of a foreign corporation that is not described in paragraphs (d)(1)(v)(A) or (d)(1)(v)(B) of this section (including assets treated as held pursuant to section 1297(c) and §1.1297–2(b)(2)(i) and (b)(3)(i), other than assets held by a look-through subsidiary described in paragraphs (d)(1)(v)(A) or (d)(1)(v)(B) of this section) are measured for all measuring periods of the taxable year on the basis of value, unless a tested foreign corporation or a shareholder makes an election under section 1297(e)(2)(B) in accordance with paragraph (d)(1)(iii) of this section. In the case of a foreign corporation that is described in paragraph (d)(1)(v)(B) of this section for some but not all measuring periods during a taxable year, this paragraph (d)(1)(v)(C)(*1*) applies to the remaining measuring period or periods during that taxable year.

(*2*) *Lower-tier subsidiaries*—(*i*) *Lower-tier subsidiaries that are publicly traded foreign corporations*. For purposes of applying section 1297(a)(2) to the assets of a foreign corporation that is a lower-tier subsidiary of a foreign corporation that directly or indirectly owns all or part of the lower-tier subsidiary (a parent foreign corporation), if the lower-tier subsidiary is described in paragraph (d)(1)(v)(A), the rules of paragraph (d)(1)(v)(A) apply. The previous sentence applies both for purposes of applying section 1297(a)(2) to the lower-tier subsidiary as a tested foreign corporation, and for purposes of applying section 1297(a)(2) to a parent foreign corporation with respect to the assets of the lower-tier subsidiary.

(*ii*) *Lower-tier subsidiaries that are non-publicly traded controlled foreign corporations*. For purposes of applying section 1297(a)(2) to the assets of a foreign corporation that is a lower-tier subsidiary of a parent foreign corporation, if the lower-tier subsidiary is described in paragraph (d)(1)(v)(B), the rules of paragraph (d)(1)(v)(B) apply. The previous sentence applies both for purposes of applying section 1297(a)(2) to the lower-tier subsidiary as a tested foreign corporation, and for purposes of applying section 1297(a)(2) to a parent foreign corporation with respect to the assets of the lower-tier subsidiary.

(*iii*) *Other lower-tier subsidiaries*. For purposes of applying section 1297(a)(2) to a foreign corporation that is a lower-tier subsidiary of a parent foreign corporation, if the lower-tier subsidiary is not described in paragraphs (d)(1)(v)(A) or (d)(1)(v)(B) of this section, the assets of the lower-tier subsidiary (including assets treated as held pursuant to section 1297(c) and §1.1297–2(b)(2)(i) and (b)(3)(i)) must be measured under the rules of the same paragraph of this section (d)(1)(v) that applies to the parent foreign corporation. The previous sentence applies both for purposes of applying section 1297(a)(2) to the lower-tier subsidiary as a tested foreign corporation, and for purposes of applying section 1297(a)(2) to a parent foreign corporation. If a tested foreign corporation indirectly owns a lower-tier subsidiary that is not described in paragraphs (d)(1)(v)(A) or (d)(1)(v)(B) of this section through one or more other foreign corporations, the status of any parent foreign corporation in that chain of corporations that is described in paragraph (d)(1)(v)(A) of this section, or if there is no such parent foreign corporation then the status of any parent foreign corporation in that chain of corporations that is described in paragraph (d)(1)(v)(B) of this section, determines the basis on which

the assets of the lower-tier subsidiary are measured. In the case of a foreign corporation that is a lower-tier subsidiary with respect to more than one parent foreign corporation, this rule applies separately to measure the assets of the lower-tier subsidiary with respect to each parent foreign corporation.

(D) [Reserved]

(E) *Examples*. The following examples illustrate the application of this paragraph (d)(1)(v).

(*1*) *Example 1*—(*i*) *Facts*. USP, a domestic corporation, owns 60% of TFC1, which is a foreign corporation. The remaining 40% of TFC1's stock is regularly traded on a national securities exchange that is registered with the Securities and Exchange Commission and continues to be until September 1 of the taxable year, when USP acquires all of TFC1's stock pursuant to a tender offer. TFC1 owns 30% of the stock of FS1, a foreign corporation that is neither a publicly traded foreign corporation nor a controlled foreign corporation.

(*ii*) *Results*. TFC1 is a controlled foreign corporation with respect to USP. TFC1 also is a publicly traded foreign corporation until September 1 of the taxable year. For purposes of section 1297, the assets of TFC1 (including the assets of FS1 treated as held by TFC1 pursuant to section 1297(c) and § 1.1297–2(b)(2)(i)) must be measured on the basis of value for each measuring period ending before September 1, pursuant to paragraph (d)(1)(v)(A) of this section. For purposes of applying section 1297 to FS1 as a tested foreign corporation with respect to USP, the assets of FS1 must be measured using the same method as is used for TFC1's assets, pursuant to paragraph (d)(1)(v)(C)(*2*) of this section.

(*2*) *Example 2*—(*i*) *Facts*. A, a United States person, owns 1% of the stock of TFC2, a foreign corporation that is neither a publicly traded foreign corporation nor a controlled foreign corporation. TFC2 owns 25% of the stock of FS2, a foreign corporation that is neither a publicly traded foreign corporation nor a controlled foreign corporation.

(*ii*) *Results*. For purposes of applying section 1297 to TFC2, the assets of TFC2 (including the assets of FS2 treated as held by TFC2 pursuant to section 1297(c) and § 1.1297–2(b)(2)(i)) are measured for all measuring periods of the taxable year on the basis of value, unless A or TFC2 makes an election under section 1297(e)(2)(B) in accordance with paragraph (d)(1)(iii) of this section, pursuant to paragraph (d)(1)(v)(C)(*1*) of this section. For purposes of applying section 1297 to FS2 as a tested foreign corporation with respect to A, the assets of FS2 must be measured using the same method as is used for TFC2's assets, pursuant to paragraph (d)(1)(v)(C)(*2*) of this section.

(*3*) *Example 3*—(*i*) *Facts*. The facts are the same as in paragraph (d)(1)(v)(E)(*2*)(*i*) (the facts in Example 2), except that the 75% of FS2's stock not owned by TFC2 is owned by TFC3, a publicly traded foreign corporation that is neither related to TFC2 nor to A. B, a United States person that is neither related to A nor to TFC2, owns 1% of the stock of TFC3.

(*ii*) *Results*. For purposes of applying section 1297 to TFC2, the results are the same as in paragraph (d)(1)(v)(E)(*2*)(*ii*) (the results in Example 2). For purposes of applying section 1297 to FS2 as a tested foreign corporation with respect to A, the assets of FS2 must be measured using the same method as is used for TFC2's assets, pursuant to paragraph (d)(1)(v)(C)(*2*) of this section. For purposes of applying section 1297 to TFC3, the assets of TFC3 must be measured by reference to value pursuant to paragraph (d)(1)(v)(A) because it is a publicly traded corporation. For purposes of applying section 1297 to FS2 as a tested foreign corporation with respect to B, the assets of FS2 must be measured by reference to value because TFC3 is a publicly traded foreign corporation, pursuant to paragraphs (d)(1)(v)(C)(*2*) and (d)(1)(v)(A) of this section.

(2) [Reserved]

(3) *Dual-character assets*—(i) *General rule*. Except as otherwise provided in paragraph (d)(3)(ii) or (d)(3)(iii) of this section and in § 1.1297–2(c), for purposes of section 1297, an asset (or portion of an asset) that produces both passive income and non-passive income during a taxable year (dual-character asset), including stock and other assets that

produce passive and non-passive income under section 1297(b)(2)(C) and paragraph (c)(4) of this section, is treated as two assets for each measuring period in the taxable year, one of which is a passive asset and one of which is a non-passive asset. The value (or adjusted basis) of the dual-character asset is allocated between the passive asset and the non-passive asset in proportion to the relative amounts of passive income and non-passive income produced by the asset (or portion of an asset) during the taxable year. See paragraph (d)(3)(iii) of this section for a special rule concerning stock that has previously produced dividends subject to the exception provided in section 1297(b)(2)(C). For purposes of section 1297(b)(2)(C), a partnership interest in a partnership that is a related person to the tested foreign corporation is treated as producing passive or non-passive income in proportion to the tested foreign corporation's distributive share of partnership passive or non-passive income for the taxable year under paragraph (c)(4)(vii) of this section.

(ii) *Special rule when only part of an asset produces income.* For purposes of section 1297, when only a portion of an asset produces income during a taxable year or a portion of a taxable year, the asset is treated as two assets for that period, one of which is characterized as a passive asset or a non-passive asset based on the income that it produces, and one of which is characterized based on the income that it is held to produce. The value (or adjusted basis) of the asset is allocated between the two assets pursuant to the method that most reasonably reflects the uses of the property. In the case of real property, an allocation based on the physical use of the property generally is the most reasonable method.

(iii) *Special rule for stock that previously produced income that was excluded from passive income under section 1297(b)(2)(C).* Stock with respect to which no dividends are received during a taxable year, but with respect to which dividends were received during one or both of the prior two taxable years, is characterized based on the relative portion of the dividends received that was passive or non-passive. If the dividends were in whole excluded from passive income under section 1297(b)(2)(C) and paragraph (c)(4)(iv) of this section, the stock is treated as a single non-passive asset. If the dividends were in part excluded from passive income under section 1297(b)(2)(C) and paragraph (c)(4)(iv) of this section, the stock is treated as two assets, one of which is a passive asset and one of which is a non-passive asset. The value (or adjusted basis) of the stock is allocated between the two assets in proportion to the average percentage of aggregate dividends received in the prior two taxable years that were characterized as passive income and the average percentage of aggregate dividends received in the prior two years that were characterized as non-passive income, for the previous two taxable years pursuant to section 1297(b)(2)(C) and paragraph (c)(4)(iv) of this section. If the tested foreign corporation did not receive any dividends from the stock for the current taxable year or within either of the prior two taxable years of the tested foreign corporation, then the stock is treated as a passive asset.

(iv) *Example.* The following example illustrates the application of this paragraph (d)(3).

(A) *Facts.* (*1*) USP is a domestic corporation that owns 30% of TFC, a foreign corporation. The remaining 70% of TFC is owned by FP, a foreign corporation that is unrelated to USP. TFC owns 20% of the value of FS1, a foreign corporation, and FP owns the remaining 80% of the value of FS1. FP, TFC, and FS1 are not controlled foreign corporations within the meaning of section 957(a), and each has a calendar year taxable year.

(*2*) In Year 1, FS1 had current earnings and profits of $1000x, attributable to passive income of $500x and non-passive income of $500x, and paid $300x of dividends to TFC. In Year 2, FS1 had current earnings and profits of $1000x, attributable to passive income of $100x and non-passive income of $900x, and paid $100x of dividends to TFC. In Year 3, FS1 has passive income of $200x and non-passive income of $800x and does not pay a dividend.

(*3*) Throughout Year 3, TFC holds an obligation of FS1 with respect to which FS1 pays $100x of interest.

(*4*) In addition to the stock in FS1 and the FS1 obligation, TFC holds an office building, 40% of which is rented to FP throughout Year 3 for $100x per quarter. During Year 3, FP has only passive income. The remaining 60% of the office building is leased throughout Year 3 to an unrelated person for $300x per quarter, and TFC's own officers or staff of employees regularly perform active and substantial management and operational functions while the property is leased.

(B) *Results.* (*1*) For purposes of section 1297(b)(2)(C), FP is a ''related person'' with respect to TFC because FP owns more than 50% of the vote or value of TFC, and FS1 is a ''related person'' with respect to TFC because FP owns more than 50% of the vote or value of both TFC and of FS1.

(*2*) Under paragraph (c)(4)(iv) of this section, the dividends paid by FS1 in Year 1 were characterized as 50% passive income ($150x) and 50% non-passive income ($150x). Under paragraph (c)(4)(iv) of this section, the dividends paid by FS1 in Year 2 were characterized as 10% passive income ($10x) and 90% non-passive income ($90x). Accordingly, the average percentage of dividends for the previous two taxable years that were characterized as passive income is 40% (((10% × $100x) + (50% × $300x))/($100x + $300x)), and the average percentage of dividends characterized as non-passive income is 60% (((90% × $100x) + (50% × $300x))/($100x + $300x)). Thus, under paragraph (d)(3)(iii) of this section, 60% of each share of stock of FS1 is characterized as a non-passive asset and 40% is characterized as a passive asset for each quarter of Year 3 for purposes of applying section 1297(a)(2) to determine whether TFC is a PFIC.

(*3*) Under paragraph (c)(4)(iii) of this section, the interest received by TFC from FS1 is characterized as 20% ($200x/($200x + $800x)) passive income and thus 80% non-passive income for purposes of applying section 1297(a)(1) to determine whether TFC is a PFIC. Accordingly, under paragraph (d)(3)(i) of this section, 20% of the obligation of FS1 is characterized as a passive asset and 80% as a non-passive asset for each quarter of Year 3 for purposes of applying section 1297(a)(2) to determine whether TFC is a PFIC.

(*4*) Under paragraph (c)(4)(v) of this section, the rent received from FP throughout Year 3 is characterized as 100% passive income. Under paragraph (c)(1)(i)(A) of this section and section 954(c)(2)(A), the rent received from the unrelated person is characterized as 100% non-passive income. Accordingly, under paragraph (d)(3)(i) of this section, the 40% of the office building rented to FP has a value of 25% (($100x × 4)/(($100x × 4) + ($300x × 4))) of the value of the office building and that 25% is a passive asset, and the 60% of the office building rented to the unrelated person has a value of 75% (($300x × 4)/(($100x × 4) + ($300x × 4))) of the value of the office building and is a non-passive asset for purposes of applying section 1297(a)(2) to determine whether TFC is a PFIC.

(4) *Passive treatment of stock and partnership interests.* For purposes of section 1297(a)(2), shares of stock in a corporation that is not a look-through subsidiary (as defined in §1.1297–2(g)(3)) and partnership interests in a partnership that is not a look-through partnership (as defined in §1.1297–2(g)(4)) with respect to a tested foreign corporation for a taxable year or portion thereof are treated as passive assets for the taxable year or relevant portion thereof, except to the extent the stock or partnership interest is treated as a dual-character asset under section 1297(b)(2)(C) and paragraph (d)(3) of this section because it produces both passive and non-passive income, or the stock or partnership interest produces solely non-passive income for the taxable year under section 1297(b)(2)(C) and paragraph (c)(4) of this section or under paragraph (d)(5) of this section.

(5) *Dealer property.* For purposes of section 1297(a)(2), an asset that produces, or would produce upon disposition, income or gain that is, or would be, excluded from passive income pursuant to section 954(c)(2)(C) is treated as a non-passive asset.

(e) *Stapled stock.* If a United States person that would be a shareholder (within the meaning of §1.1291–1(b)(7) and (b)(8)) of a stapled entity (as defined in section 269B(c)(2)) owns stock in all entities that are stapled entities

with respect to each other and the shares are stapled interests (as defined in section 269B(c)(3)), the United States person's interests in the stapled entities are treated as an interest in a single entity that holds all of the assets of the stapled entities, conducts all of the activities of the stapled entities, and derives all of the income of the stapled entities for all purposes of the PFIC regime.

(f) *Definitions*. The following definitions apply for purposes of this section and § 1.1297–2:

(1) *Measuring date*. The term *measuring date* has the meaning provided in paragraph (d)(1)(i) of this section.

(2) *Measuring period*. The term *measuring period* means a three-month period or an alternative measuring period, within the meaning provided in paragraph (d)(1)(ii) of this section.

(3) *Non-passive asset*. The term *non-passive asset* means an asset other than a passive asset.

(4) *Non-passive income*. The term *non-passive income* means income other than passive income.

(5) *Passive asset*. The term *passive asset* means an asset that produces passive income, or which is held for the production of passive income, taking into account the rules in paragraphs (c) and (d) of this section.

(6) *Passive income*. The term *passive income* has the meaning provided in paragraph (c)(1) of this section.

(7) *Publicly traded foreign corporation*. The term *publicly traded foreign corporation* means a foreign corporation the stock of which is regularly traded on an exchange described in section 1297(e)(3), other than in de minimis quantities, for at least twenty trading days during a taxable year.

(8) *Related person*. For purposes of applying the rules of this section and § 1.1297–2 with respect to section 1297(b)(2)(C), the term means a *related person* within the meaning of section 954(d)(3).

(9) *Tested foreign corporation*. The term *tested foreign corporation* means a foreign corporation the PFIC status of which is being tested under section 1297(a).

(g) *Applicability date*—(1) *In general*. Except as otherwise provided in paragraph (g)(2) of this section, the rules of this section apply to taxable years of shareholders beginning on or after January 14, 2021. A shareholder may choose to apply such rules for any open taxable year beginning before January 14, 2021, provided that, with respect to a tested foreign corporation, the shareholder consistently applies the provisions of this section (except that consistent treatment is not required with respect to paragraph (c)(1)(i)(A) of this section) and § 1.1291–1(b)(8)(iv) and (b)(8)(v)(A), (B), (C), and (D) and §§ 1.1297–2, 1.1298–2, and 1.1298–4 for such year and all subsequent years.

(2) *Paragraph (d)(1)(v)(B)(2) of this section*. Paragraph (d)(1)(v)(B)(*2*) of this section applies to taxable years of shareholders ending on or after October 1, 2019. For taxable years of shareholders ending before October 1, 2019, a shareholder may apply paragraph (d)(1)(v)(B)(*2*) of this section to the last taxable year of a foreign corporation beginning before January 1, 2018, and each subsequent taxable year of the foreign corporation, provided that the shareholder and United States persons that are related (within the meaning of section 267 or 707) to the taxpayer consistently apply such paragraph with respect to all foreign corporations.

[T.D. 9936, 86 FR 4557, Jan. 15, 2021, as amended at 86 FR 13648, Mar. 10, 2021]

§ 1.1297–2 Special rules regarding look-through subsidiaries and look-through partnerships.

(a) *Overview*. This section provides rules concerning the treatment of income and assets of a look-through subsidiary (as defined in § 1.1297–2(g)(3)) or look-through partnership (as defined in § 1.1297–2(g)(4)) for purposes of determining whether a tested foreign corporation (as defined in § 1.1297–1(f)(9)) is a passive foreign investment company (PFIC) under section 1297(a). Paragraph (b) of this section provides guidance for purposes of section 1297(c) on how to determine a tested foreign corporation's ownership in a corporation and how to determine a tested foreign corporation's proportionate share of a look-through subsidiary's or look-through partnership's assets and income. Paragraph (c) of this section provides rules that eliminate certain income and assets related to look-

through subsidiaries and look-through partnerships for purposes of determining a tested foreign corporation's PFIC status. Paragraph (d) of this section provides a rule to determine whether certain income received or accrued by look-through subsidiaries and look-through partnerships is received or accrued from a related person for purposes of section 1297(b)(2)(C). Paragraph (e) of this section provides rules concerning the attribution of activities from qualified affiliates (as defined in §1.1297–2(e)(2)) for purposes of characterizing the income and assets of a look-through subsidiary or look-through partnership. Paragraph (f) of this section provides rules for determining the amount of gain from the direct or indirect sale or exchange of stock of a look-through subsidiary or partnership interests in a partnership described in section 954(c)(4) that is taken into account under section 1297(a) and for determining the passive or non-passive character of gain from the sale of a look-through subsidiary. Paragraph (g) of this section provides definitions applicable for this section, and paragraph (h) of this section provides the applicability date of this section.

(b) *General rules*—(1) *Tested foreign corporation's ownership of a corporation.* For purposes of section 1297(c) and this section, the principles of section 958(a) and the regulations in this chapter under that section applicable to determining direct or indirect ownership by value apply to determine a tested foreign corporation's percentage ownership (by value) in the stock of another corporation. These principles apply whether an intermediate entity is domestic or foreign.

(2) *Tested foreign corporation's proportionate share of the assets and income of a look-through subsidiary*—(i) *Proportionate share of subsidiary assets.* For each measuring period (as defined in §1.1297–1(f)(2)), a tested foreign corporation is treated as if it held its proportionate share of each asset of a look-through subsidiary, determined based on the tested foreign corporation's percentage ownership (by value) (as determined under paragraph (b)(1) of this section)) of the look-through subsidiary on the measuring date (as defined in §1.1297–1(f)(1)). A tested foreign corporation's proportionate share of a look-through subsidiary's asset is treated as producing passive income, or being held to produce passive income, to the extent the asset produced, or was held to produce, passive income in the hands of such look-through subsidiary under the rules of paragraph (b)(2)(ii) of this section.

(ii) *Proportionate share of subsidiary income*—(A) *General rule.* A tested foreign corporation is treated as if it received directly its proportionate share of each item of gross income or loss of a corporation for a taxable year if the corporation is a look-through subsidiary with respect to the tested foreign corporation for the taxable year of the tested foreign corporation. In such case, a tested foreign corporation's proportionate share of a look-through subsidiary's gross income or loss is determined based on the corporation's average percentage ownership (by value) of the look-through subsidiary. The exceptions to passive income in section 1297(b)(2) and the relevant exceptions to foreign personal holding company income in section 954(c) that are based on whether income is derived in the active conduct of a business or whether a corporation is engaged in the active conduct of a business apply to such income only if the exception would have applied to exclude the income from passive income or foreign personal holding company income in the hands of the subsidiary, determined by taking into account only the activities of the subsidiary except as provided in paragraph (e) of this section. See paragraph (d) of this section for rules determining whether a person is a related person for purposes of applying section 1297(b)(2)(C) in the case of income received or accrued by a subsidiary that is treated as received directly by a tested foreign corporation pursuant to this paragraph (b)(2).

(B) *Partial year.* When a corporation is not a look-through subsidiary with respect to a tested foreign corporation for an entire taxable year of the tested foreign corporation, the tested foreign corporation may be treated as if it received directly its proportionate share of the gross income or loss of the first corporation for each measuring period

in the year for which the first corporation is a look-through subsidiary, if the conditions in paragraph (g)(3)(ii)(B) of this section are satisfied. In such case, a tested foreign corporation's proportionate share of a look-through subsidiary's gross income or loss is determined based on the tested foreign corporation's percentage ownership (by value) (as determined under paragraph (b)(1) of this section) of the look-through subsidiary on the relevant measuring date.

(iii) *Coordination of section 1297(c) with section 1298(b)(7).* A tested foreign corporation is not treated under section 1297(c) and this paragraph (b) as holding its proportionate share of the assets of a domestic corporation, or receiving directly its proportionate share of the gross income or loss of the domestic corporation, if the stock of the domestic corporation is treated as an asset that is not a passive asset (as defined in § 1.1297–1(f)(5)) that produces income that is not passive income (as defined in § 1.1297–1(f)(6)) under section 1298(b)(7) (concerning the treatment of certain foreign corporations owning stock in certain 25-percent-owned domestic corporations). See § 1.1298–4 for rules governing the application of section 1298(b)(7).

(3) *Tested foreign corporation's proportionate share of the assets and income of a look-through partnership*—(i) *Proportionate share of partnership assets.* For each measuring period (as defined in § 1.1297–1(f)(2)), a tested foreign corporation is treated as if it held its proportionate share of each asset of a look-through partnership, determined based on the tested foreign corporation's percentage ownership (by value) (as determined under paragraph (b)(1) of this section) of the look-through partnership on the measuring date (as defined in § 1.1297–1(f)(1)). A tested foreign corporation's proportionate share of a look-through partnership's asset is treated as producing passive income, or being held to produce passive income, to the extent the asset produced, or was held to produce, passive income in the hands of the partnership under the rules in paragraph (b)(3)(ii) of this section.

(ii) *Proportionate share of partnership income*—(A) *General rule.* A tested foreign corporation is treated as if it received directly its proportionate share of any item of gross income or loss of a partnership that is a look-through partnership with respect to the tested foreign corporation for the taxable year of the tested foreign corporation. The exceptions to passive income in section 1297(b)(2) and the relevant exceptions to foreign personal holding company income in section 954(c) that are based on whether income is derived in the active conduct of a business or whether a corporation is engaged in the active conduct of a business apply to such income only if the exception would have applied to exclude the income from passive income or foreign personal holding company income in the hands of the partnership, determined by taking into account only the activities of the partnership except as provided in paragraph (e) of this section. See paragraph (d) of this section for rules determining whether a person is a related person for purposes of applying section 1297(b)(2)(C) in the case of income received or accrued by a partnership that is treated as received directly by a tested foreign corporation pursuant to this paragraph (b)(3).

(B) *Partial year.* When a partnership is not a look-through partnership with respect to a tested foreign corporation for an entire taxable year of the tested foreign corporation, the tested foreign corporation may be treated as if it received directly its proportionate share of the gross income of the partnership for each measuring period in the year for which the partnership is a look-through partnership, provided that the conditions set forth in paragraph (g)(3)(ii)(B) of this section would be satisfied if the partnership were a corporation.

(4) *Examples.* The following examples illustrate the rules of this paragraph (b). For purposes of these examples, USP is a domestic corporation; TFC, LTS, and FS are foreign corporations that are not controlled foreign corporations within the meaning of section 957(a); USP owns 30% of TFC; and LTS owns 25% of the only class of FS stock.

(i) *Example 1*—(A) *Facts.* TFC directly owns 80% of the only class of LTS stock for TFC's and LTS's entire taxable year.

(B) *Results*—(*1*) *LTS*. Under paragraph (b)(1) of this section and pursuant to the principles of section 958(a), LTS owns 25% of the value of FS. Under paragraph (b)(2)(i) and (ii) of this section, in determining whether LTS is a PFIC under section 1297(a), LTS is treated as if it held 25% of each of FS's assets on each of the measuring dates in its taxable year and received directly 25% of the gross income of FS for the taxable year.

(*2*) *TFC*. Under paragraph (b)(1) of this section and pursuant to the principles of section 958(a), TFC owns 80% of the value of LTS and indirectly owns 20% of the value of FS. Under paragraph (b)(2) of this section, in determining whether TFC is a PFIC under section 1297(a), TFC is treated as if it held 80% of each of LTS's assets on each of the measuring dates in its taxable year and received directly 80% of the gross income of LTS for the taxable year. However, because TFC indirectly owns less than 25% of FS, FS is not a look-through subsidiary with respect to TFC and, therefore, TFC is treated as if it held a 20% interest in the stock of FS (and not the assets of FS), and received 80% of any dividends paid from FS to LTS (and not any income of FS).

(ii) *Example 2*—(A) *Facts*. TFC directly owns 25% of the only class of LTS stock on the last day of each of the first three quarters of its taxable year but disposes of its entire interest in LTS during the fourth quarter of its taxable year.

(B) *Results*. Under paragraph (b)(1) and pursuant to the principles of section 958(a), on each of its first three measuring dates, TFC owns 25% of the value of LTS and indirectly owns 6.25% of the value of FS. Under paragraph (g)(3) of this section, if information about the gross income of LTS for each of the first three quarters of its taxable year is available to TFC, LTS is treated as a look-through subsidiary with respect to TFC for those quarters because TFC owned 25% of the value of LTS on the measuring dates with respect to those measuring periods. In that case, under paragraph (b)(2) of this section, in determining whether TFC is a PFIC under section 1297(a), TFC is treated as if it held 25% of each of LTS's assets and received directly 25% of the gross income of LTS on each of the first three measuring dates in its taxable year. For each of its first three quarters, if LTS is treated as a look-through subsidiary with respect to TFC under paragraph (g)(3) of this section, then TFC is treated as if it held a 6.25% interest in the stock of FS (and not the assets of FS) and received 25% of any dividends paid from FS to LTS (and not any income of FS). Under paragraph (g)(3) of this section, if information about the gross income of LTS for each of the first three quarters of its taxable year is not available to TFC, then LTS is not a look-through subsidiary with respect to TFC.

(iii) *Example 3*—(A) *Facts*. TFC directly owns 100% of the only class of LTS stock for TFC's and LTS's entire taxable year. TFC sells one item of property described in section 954(c)(1)(B)(i) for a gain of $25x and another for a loss of $10x, and no exception from passive income applies to either amount. During the taxable year, FS sells one item of property described in section 954(c)(1)(B)(i) for a gain of $50x and another for a loss of $55x; no exception from passive income applies to either amount.

(B) *Results*. Under paragraph (b)(1) of this section and pursuant to the principles of section 958(a), TFC owns 100% of the value of LTS, and TFC indirectly owns 25% of the value of FS. Under paragraph (b) of this section, in determining whether TFC is a PFIC under section 1297(a), TFC is treated as if it held 100% of LTS's assets on each of the measuring dates in its taxable year and received directly 100% of the gross income of LTS for the taxable year. Furthermore, TFC is treated as if it held 25% of each of FS's assets and received directly 25% of the gross income of FS. Pursuant to §1.1297–1(c)(1)(ii), the excess of gains over losses from property transactions described in section 954(c)(1)(B) is taken into account as gross income for purposes of section 1297, and items of gain or loss of look-through subsidiaries are treated as recognized by a tested foreign corporation. Accordingly, TFC takes into account the net $5x loss from the sales of property by FS. TFC's income from its

own sales of property constitutes passive income pursuant to §1.1297–1(c) and section 954(c)(1)(B), although, pursuant to §1.1297–1(c)(1)(ii), only the excess of gains over losses, $15x ($25x − $10x), is taken into account as gross income for purposes of section 1297. As a result, TFC's income (including the $5x loss from FS), all of which is passive income, equals $10x ($15x − $5x) of gross income.

(c) *Elimination of certain intercompany assets and income*—(1) *General rule for asset test*—(i) *LTS stock*. For purposes of section 1297(a)(2), a tested foreign corporation does not take into account the value (or adjusted basis) of stock of a look-through subsidiary (*LTS stock*), including LTS stock that the tested foreign corporation is treated as owning on a measuring date pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section. Furthermore, for purposes of section 1297(a)(2), a tested foreign corporation does not take into account the value (or adjusted basis) of its own stock that it is treated as owning on a measuring date pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section.

(ii) *LTS obligation*. For purposes of section 1297(a)(2), a tested foreign corporation does not take into account the value (or adjusted basis) of its proportionate share of a direct LTS obligation, an indirect LTS obligation or a TFC obligation that it is treated as owning on a measuring date. The term *direct LTS obligation* means a debt obligation of, lease to, or license to a look-through subsidiary (*LTS debt*, *LTS lease*, and *LTS license*, respectively, and *LTS obligation* collectively) from the tested foreign corporation that the tested foreign corporation owns on a measuring date, and the term *indirect LTS obligation* means a LTS obligation from a look-through subsidiary that the tested foreign corporation is treated as owning on a measuring date pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section. The term *TFC obligation* means a debt obligation of, lease to, or a license to the tested foreign corporation from a look-through subsidiary that the tested foreign corporation is treated as owning on a measuring date pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section. The tested foreign corporation's proportionate share of a LTS obligation or a TFC obligation is the value (or adjusted basis) of the item multiplied by the tested foreign corporation's percentage ownership (by value) in each relevant look-through subsidiary. For purposes of section 1297(a)(2) and §1.1297–1(d) as applied to a tested foreign corporation, property subject to a LTS lease or LTS license or a lease or license to the tested foreign corporation is characterized as either producing passive income or non-passive income (or both) by taking into account the activities of the qualified affiliates (as defined in paragraph (e)(2) of this section) of the entity that owns the property. For this purpose, the activities of the entity that owns the property that is subject to the lease or license are not taken into account to the extent that they relate to the lease or license.

(2) *General rule for income test*—(i) *LTS stock*. For purposes of section 1297(a)(1), a tested foreign corporation does not take into account dividends derived with respect to LTS stock, including dividends that the tested foreign corporation is treated as receiving on a measuring date pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section; provided that, notwithstanding the foregoing, a tested foreign corporation takes into account dividends that are attributable to income that was not treated as received directly by the tested foreign corporation pursuant to paragraph (b)(2) of this section. For this purpose, the rules of §1.1297–1(c)(4)(iv)(A) apply to determine the earnings and profits from which a dividend is paid, substituting the term ''look-through subsidiary'' for ''related person.''

(ii) *LTS obligation*. For purposes of section 1297(a)(1), a tested foreign corporation does not take into account its proportionate share of interest, rents, or royalties derived with respect to direct or indirect LTS obligations or TFC obligations. The tested foreign corporation's proportionate share of interest, rents, or royalties is the amount of the item multiplied by the tested foreign corporation's percentage ownership (by value) in each relevant look-through subsidiary.

(3) *Partnerships*. For purposes of section 1297(a)(1) and (a)(2), the principles of paragraphs (c)(1) and (2) of this section apply with respect to ownership interests in, debt of, and leases or licenses to a look-through partnership (as defined in paragraph (g)(4) of this section), and with respect to distributions and the distributive shares of income from a look-through partnership and interest, rents, or royalties derived with respect to the debt, leases or licenses of a look-through partnership.

(4) *Examples*. The following examples illustrate the rules of this paragraph (c). For purposes of these examples, USP is a domestic corporation; USP owns 30% of TFC; TFC, LTS, LTS1, LTS2, and FS are foreign corporations that are not controlled foreign corporations within the meaning of section 957(a); FPS is a foreign partnership; and TFC, LTS1, and LTS2 measure assets for purposes of section 1297(a)(2) based on value.

(i) *Example 1*—(A) *Facts*. TFC directly owns 80% of the only class of LTS stock for TFC's and LTS's entire taxable year, and LTS is a look-through subsidiary (as defined in paragraph (g)(3) of this section) with respect to TFC. LTS owns 25% of the only class of FS stock, and FS is a look-through subsidiary with respect to LTS. Pursuant to the principles of section 958(a), TFC owns 80% of the value of LTS, LTS owns 25% of the value of FS, and TFC indirectly owns 20% of the value of FS. During the first quarter of the taxable year, LTS received a $20x dividend from FS.

(B) *Results*—(*1*) *LTS*. Under paragraph (c)(1)(i) of this section, for purposes of applying section 1297(a)(2) to LTS, LTS's assets do not include the stock of FS. Under paragraph (c)(2)(i) of this section, for purposes of applying section 1297(a)(1) to LTS, LTS's income does not include the $20x dividend from FS.

(*2*) *TFC*. Under paragraph (c)(1)(i) of this section, for purposes of applying section 1297(a)(2) to TFC, TFC's assets do not include the stock of LTS. Under paragraph (b)(2)(ii)(A) of this section, for purposes of applying section 1297(a)(1) to TFC, TFC is treated as receiving directly the income of LTS. Because TFC indirectly owns less than 25% of FS, FS is not a look-through subsidiary with respect to TFC and, therefore, TFC's assets include the value of TFC's 20% interest in the stock of FS and do not include 20% of FS's assets. Similarly, TFC is treated as if it received $16x (80% × $20x) of the $20x dividend paid from FS to LTS (and not any income of FS). Because the dividend constitutes gross income to LTS (although it is eliminated for purposes of applying section 1297(a)(1) to LTS), TFC is treated as receiving the dividend from FS directly under paragraph (b)(2)(ii)(A) of this section. Because the dividend is from a subsidiary that is not a look-through subsidiary with respect to TFC, paragraph (c)(2)(i) of this section does not apply to eliminate the $16x dividend for purposes of section 1297(a).

(ii) *Example 2*—(A) *Facts*. TFC directly owns 40% of the value of LTS1 stock on each of the measuring dates, and thus is treated under paragraph (b)(1) of this section as owning 40% of LTS1's assets on each of the measuring dates. TFC's assets include a loan to LTS1 with a balance of $1,000x on each of the measuring dates. During the first quarter of the taxable year, TFC received $20x of dividends from LTS1, which were attributable to income of LTS1 treated as received directly by TFC pursuant to paragraph (b)(2) of this section, and $30x of interest on the loan, both of which were paid in cash.

(B) *Results*. Under paragraph (c)(1)(i) of this section, for purposes of applying section 1297(a), TFC's assets do not include the stock of LTS1, and TFC's income does not include the $20x of dividends received from LTS1 pursuant to paragraph (c)(2)(i) of this section. Similarly, under paragraph (c)(1)(ii) of this section TFC's assets include only $600x ($1,000x loan −(40% × $1,000x)) of the loan to LTS1, and under paragraph (c)(2)(ii) of this section, TFC's income includes only $18x ($30x interest − (40% × $30x)) of the interest from LTS1. However, TFC's assets include the entire $50x of cash ($20x of dividends and $30x of interest) received from LTS1.

(iii) *Example 3*—(A) *Facts*. The facts are the same as in paragraph (c)(4)(ii)(A) of this section (the facts in *Example 2*), except that TFC also directly owns 30% of the value of LTS2

stock on each of the measuring dates, and thus is treated under paragraph (b)(1) of this section as owning 30% of LTS2's assets, and LTS1's assets also include a loan to LTS2 with a balance of $200x on each of the measuring dates. During the first quarter of the taxable year, LTS1 received $5x of interest on the loan, which was paid in cash.

(B) *Results*. The results are the same as in paragraph (c)(4)(ii)(B) of this section (the results in *Example 2*), except that TFC's assets also do not include the stock of LTS2. Similarly, although TFC would be treated under paragraph (b)(2) of this section as owning $80x (40% × $200x) of the LTS1 loan to LTS2, under paragraph (c)(1)(ii) of this section TFC does not take into account its proportionate share of an indirect LTS obligation and accordingly, TFC does not take into account $24x (30% × $80x) of the loan to LTS2. As a result, TFC's assets include only $56x ($80x − $24x) of the LTS1 loan to LTS2. Furthermore, although TFC would be treated under paragraph (b)(2) of this section as receiving $2x (40% × $5x) of the interest received by LTS1 from LTS2, under paragraph (c)(2)(ii) of this section TFC does not take into account its proportionate share of interest with respect to an indirect LTS obligation and thus, TFC does not take into account $0.60x (30% × $2x) of the interest received by LTS1. Accordingly, TFC's income includes only $1.40x ($2x − $0.60x) of the interest from LTS2. Furthermore, TFC's assets include $2x (40% × $5x) of LTS1's cash received from LTS2.

(iv) *Example 4*—(A) *Facts*. TFC directly owns 80% of the value of LTS1 stock on each of the measuring dates, and thus is treated under paragraph (b)(1) of this section as owning 80% of LTS1's assets on each of the measuring dates. TFC also directly owns 50% of the value in FPS on each of the measuring dates. LTS1's assets include the remaining 50% of the value in FPS and a loan to FPS with a balance of $500x on each of the measuring dates. FPS's assets include a loan to TFC with a balance of $1000x on each of the measuring dates. During the first measuring period of the taxable year, FPS received $30x of interest from TFC, and LTS1 received $15x of interest from FPS, both of which were paid in cash. During the last measuring period of the taxable year, FPS received $80x of income from an unrelated person in cash and distributed $60x of such income in cash to TFC and LTS1 in proportion to their interests in FPS.

(B) *Results*. Under paragraph (c)(1)(i) and (ii) of this section, for purposes of applying section 1297(a), TFC's assets do not include the stock of LTS1, the interests in FPS owned by TFC directly and through LTS1, any of the loan by FPS to TFC, or any of the loan by LTS1 to FPS. Similarly, under paragraph (c)(2)(i) and (ii) of this section, TFC's income does not include any of the $30x of interest received by FPS from TFC, any of the $15x of interest received by LTS1 from FPS, or any of the $60x of distributions received by TFC and LTS1 from FPS. However, on each of the measuring dates, TFC's assets include $27x ((50% × $30x) + (80% × 50% × $30x)) of the $30 of cash received by FPS from TFC and $12x (80% × $15x) of the $15x of cash received by LTS1 from FPS. Moreover, on the last measuring date of the taxable year, TFC's assets include $18x ((50% × $20x) + (80% × 50% × $20x)) of the $20x ($80x − $60x) of cash received by FPS from the unrelated person and retained by FPS and $54x ((50% × $60x) + (80% × 50% × $60x)) of the $60x cash received by FPS from the unrelated person and distributed. Furthermore, TFC's income includes $72x ((50% × $80x) + (80% × 50% × $80x)) of the $80x of income received by FPS from an unrelated person.

(v) *Example 5*—(A) *Facts*. TFC directly owns 80% of the value of the stock of LTS1 and 60% of the value of the stock of LTS2 on each of the measuring dates, and thus is treated under paragraph (b)(1) of this section as owning 80% of LTS1's assets and 60% of LTS2's assets on each of the measuring dates. TFC's assets include a license for the use of its intangible property by LTS1 with a value of $5,000x on each of the measuring dates, LTS1's assets include a sub-license of such license to LTS2 with a value of $2,000x on each of the measuring dates, and LTS2's assets include a lease of its building to LTS1 with a value of $4,000x on each of the measuring dates. LTS1 and LTS2 each

use the intangible property that is the subject of the license and sub-license in its respective trade or business, and LTS1 uses the building in its trade or business. During the last quarter of the taxable year, TFC received a royalty of $500x from LTS1 with respect to the license, and LTS1 received a royalty of $200x from LTS2 with respect to the sub-license, both of which were paid in cash. LTS2 received $100x of rent paid in cash from LTS1 during each quarter of the taxable year with respect to the building lease.

(B) *Results*—(*1*) *Asset test*. Under paragraph (c) of this section, for purposes of applying section 1297(a)(2) to TFC's final measuring period, the following analysis applies. TFC's assets do not include the stock of LTS1 and LTS2. Similarly, TFC's assets include only $1,000x ($5,000x license − (80% × $5,000x)) of the license to LTS1. However, TFC's assets include the entire $500x of cash it received from LTS1 as a result of the royalty. Moreover, although TFC would be treated under paragraph (b)(2) of this section as owning $1,600x (80% × $2,000x) of the LTS1 sub-license to LTS2, under paragraph (c)(1)(ii) of this section TFC does not take into account its proportionate share of an indirect LTS obligation, and accordingly TFC does not take into account $960x (60% × $1,600x) of LTS1's sub-license to LTS2. As a result, TFC's assets include $640x($1,600x − $960x) of the sub-license. In addition, TFC's assets include $160x (80% × $200x) of LTS1's cash received from LTS2 as a result of the royalty to LTS1. Similarly, although TFC would be treated under paragraph (b)(2) of this section as owning $2,400x (60% × $4,000x) of the LTS2 lease to LTS1, under paragraph (c)(1)(ii) of this section TFC does not take into account $1,920x (80% × $2,400x) of the LTS2 building lease, and accordingly, its assets include $480x ($2,400x − $1,920x) of the lease. TFC's assets also include $240x (60% × $100x × 4) of LTS2's cash received from LTS1 as a result of the rental payment to LTS2.

(*2*) *Income test*. Under paragraph (c)(2)(ii) of this section, because TFC does not take into account its proportionate share of a direct LTS obligation, TFC's income includes only $100x ($500x royalty − (80% × $500x)) of the royalties from LTS1. Furthermore, although TFC would be treated under paragraph (b)(2) of this section as receiving $160x (80% × $200x) of the royalty received by LTS1 from LTS2, under paragraph (c)(2)(ii) of this section TFC does not take into account its proportionate share of royalties derived with respect to an indirect LTS obligation, and accordingly TFC does not take into account $96x (60% × $160x) of the royalty received by LTS1. As a result, TFC's income includes only $64x ($160x − $96x) of the royalty from LTS2. Similarly, although TFC would be treated under paragraph (b)(2) of this section as receiving $240x (60% × $100x × 4) of the rent received by LTS2 from LTS1, under paragraph (c)(2)(ii) of this section TFC does not take into account its proportionate share of rent derived with respect to an indirect LTS obligation, and accordingly TFC does not take into account $192x (80% × $240) of the rent received by LTS2. Therefore, TFC's income includes only $48 ($240x − $192x) of the rent received from LTS1.

(*3*) *Treatment of intangible and rental property*. For purposes of determining whether the intangible property that TFC owns and the building that TFC is treated as owning under paragraph (b)(2) of this section is held in the production of passive income, the activities performed by TFC and its qualified affiliates with respect to the property are taken into account under paragraphs (c)(1)(ii) and (e) of this section. Because TFC is the common parent of the affiliated group (as determined under paragraph (e)(2) of this section) that includes LTS1 and LTS2, LTS1 and LTS2 are qualified affiliates of TFC and the activities of their officers and employees with respect to the intangible property and building are taken into account to determine whether the building and intangible property would be treated as passive assets.

(d) *Related person determination for purposes of section 1297(b)(2)(C)*—(1) *General rule*. For purposes of section 1297(b)(2)(C), interest, dividends, rents or royalties received or accrued by a look-through subsidiary (and treated as received directly by a tested foreign corporation pursuant to section 1297(c)

and paragraph (b)(2) of this section) are considered received or accrued from a related person only if the payor of the interest, dividend, rent or royalty is a related person (within the meaning of section 954(d)(3)) with respect to the look-through subsidiary, taking into account §1.1297–1(c)(1)(i)(D). Similarly, for purposes of 1297(b)(2)(C), interest, dividends, rents or royalties received or accrued by a look-through partnership (and treated as received directly by a tested foreign corporation pursuant to paragraph (b)(3) of this section) are considered received or accrued from a related person only if the payor of the interest, dividend, rent or royalty is a related person (within the meaning of section 954(d)(3)) with respect to the look-through partnership, taking into account §1.1297–1(c)(1)(i)(D).

(2) *Example*. The following example illustrates the rule of this paragraph (d).

(i) *Facts*. USP is a domestic corporation that owns 30% of TFC. TFC directly owns 30% of the value of FS1 stock, and thus under paragraph (b) of this section is treated as owning 30% of FS1's assets and earning 30% of FS1's gross income. The remaining FS1 stock is owned by an unrelated foreign person. FS1 directly owns 60% of the vote of FS2 stock and 20% of the value of FS2 stock. The remaining vote and value of FS2 stock are owned by an unrelated foreign person. TFC, FS1, and FS2 are foreign corporations that are not controlled foreign corporations within the meaning of section 957(a). FS1 receives a $100x dividend from FS2.

(ii) *Results*. Pursuant to section 1297(c) and paragraph (b)(2) of this section, TFC is treated as receiving directly $30x of the dividend income received by FS1. FS2 is a related person (within the meaning of section 954(d)(3)) with respect to FS1 for purposes of section 1297(b)(2)(C) because FS1 owns more than 50% of the vote of FS2. FS2 is not a related person (within the meaning of section 954(d)(3)) with respect to TFC for purposes of section 1297(b)(2)(C) because TFC indirectly does not own more than 50% of the vote or value of the FS2 stock. Under paragraph (d)(1) of this section, for purposes of determining whether the dividend income received by FS1 is subject to the exception in section 1297(b)(2)(C) for purposes of testing the PFIC status of TFC, the dividend is treated as received from a related person because FS1 and FS2 are related persons within the meaning of section 1297(b)(2)(C). Therefore, to the extent the dividend income received by FS1 would be properly allocable to income of FS2 that is not passive income, the dividend income that TFC is treated as receiving under section 1297(c) and paragraph (b)(2)(ii) of this section is treated as non-passive income (as defined in §1.1297–1(f)(4)).

(e) *Treatment of activities of certain look-through subsidiaries and look-through partnerships for purposes of certain exceptions*—(1) *General rule*. An item of income received by a tested foreign corporation (including an amount treated as received or accrued pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section) that would be passive income in the hands of the entity that actually received or accrued it is not passive if the item would be excluded from foreign personal holding company income under the following exceptions contained in section 954(c) that are based on whether the entity is engaged in the active conduct of a trade or business, determined by taking into account the activities performed by the officers and employees of the tested foreign corporation as well as activities performed by the officers and employees of any qualified affiliate of the tested foreign corporation—

(i) Section 954(c)(1)(B) and §1.954–2(e)(1)(ii) and (3)(ii), (iii) and (iv);

(ii) Section 954(c)(1)(C) and §1.954–2(f)(1)(ii) and (2)(iii)(D);

(iii) Section 954(c)(1)(D) and §1.954–2(g)(2)(ii);

(iv) Section 954(c)(2)(A) and §1.954–2(b)(6), (c), and (d);

(v) Section 954(c)(2)(B) and §1.954–2(b)(2); and

(vi) Section 954(c)(2)(C) and §1.954–2(h)(3)(ii).

(2) *Qualified affiliate*. The term *qualified affiliate* means a corporation or a partnership that is included in an affiliated group that includes the tested foreign corporation. For purposes of this paragraph (e), the term *affiliated*

group has the meaning provided in section 1504(a), except that—

(i) The affiliated group is determined without regard to sections 1504(a)(2)(A), (b)(2) and (b)(3);

(ii) Subject to paragraph (e)(2)(iii) of this section, a partnership is treated as an includible corporation;

(iii) The common parent of the affiliated group is not a domestic corporation or domestic partnership;

(iv) Section 1504(a)(2)(B) is applied by substituting ''more than 50 percent'' for ''at least 80 percent'';

(v) A foreign corporation or foreign partnership must be the common parent of the affiliated group;

(vi) Subject to paragraph (e)(2)(vii) of this section, a partnership is included as a member of the affiliated group if more than 50 percent of the value of its capital interests or profits interests is owned by one or more corporations or partnerships that are included in the affiliated group; and

(vii) A corporation or a partnership that is not the common parent of an affiliated group is included in the affiliated group only if it would be a look-through subsidiary or look-through partnership, as applicable, of the common parent if the common parent were a tested foreign corporation.

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

(i) *Example 1*—(A) *Facts*. USP is a domestic corporation that directly owns 20% of the outstanding stock of FS1. The remaining 80% of the outstanding stock of FS1 is directly owned by a foreign person that is not related to USP. FS1 directly owns 100% of the value of the outstanding stock of FS2 and directly owns 80% of the value of the outstanding stock of FS3. The remaining 20% of the value of the outstanding stock of FS3 is directly owned by a foreign person that is not related to USP. FS2 directly owns 80% of the value of the outstanding stock of FS4. The remaining 20% of the value of the outstanding stock of FS4 is directly owned by a foreign person that is not related to USP. FS1, FS2, FS3 and FS4 are all organized in Country A and are not controlled foreign corporations within the meaning of section 957(a). FS4 owns real property that is leased to a person that is not a related person, but does not perform any activities. FS1 and FS2 also do not perform any activities. Officers and employees of FS3 in Country A perform activities with respect to the real property of FS4 that, if performed by officers or employees of FS4, would allow the rental income in the hands of FS4 to qualify for the exception from foreign personal holding company income in section 954(c)(2)(A) and § 1.954–2(b)(6) and (c)(1)(ii).

(B) *Results*—(*1*) *Qualified affiliates*. FS1 is the common parent of the affiliated group (as determined under paragraph (e)(2) of this section) that includes FS2, FS3, and FS4 because (i) FS1 owns more than 50% by value of FS2 and FS3, (ii) FS2 owns more than 50% by value of FS4, and (iii) FS2, FS3, and FS4 would be look-through subsidiaries with respect to FS1 if FS1 were the tested foreign corporation. Accordingly, each of FS1, FS2, FS3 and FS4 are qualified affiliates (as determined under paragraph (e)(2) of this section) with respect to the other members of the group for purposes of determining whether FS1, FS2, FS3, or FS4 is a PFIC.

(*2*) *FS1 and FS2*. Under this paragraph (e), for purposes of determining whether the rental income actually received by FS4 with respect to the real property owned and rented by FS4 and treated under section 1297(c) and paragraph (b)(2) of this section as received directly by FS1 or by FS2, respectively, is passive income for purposes of section 1297, the activities of FS3 are taken into account because FS3 is a qualified affiliate of FS1 and FS2, respectively. Thus, the exception in section 954(c)(2)(A) would apply, and the rental income treated as received by FS1 or by FS2, respectively, would be treated as non-passive income for purposes of determining whether FS1 or FS2 is a PFIC.

(*3*) *FS4*. Under this paragraph (e), for purposes of determining whether the rental income received by FS4 with respect to the real property owned and rented by FS4 is passive income for purposes of section 1297, the activities of FS3 are taken into account, because FS3 is a qualified affiliate of FS4. Thus, the exception in section 954(c)(2)(A) would apply, and the rental

income received by FS4 would be treated as non-passive income for purposes of determining whether FS4 is a PFIC.

(ii) *Example 2*—(A) *Facts*. The facts are the same as in paragraph (e)(3)(i)(A) of this section (the facts in *Example 1*), except that FS2 also owns real property that is leased to a person that is not a related person, and the officers and employees of FS2 in Country A engage in activities that would allow rental income received by FS2 with respect to its real property to qualify for the exception in section 954(c)(2)(A) and § 1.954–2(b)(6) and (c)(1)(iv), relying on the rule in § 1.954–2(c)(2)(ii) that provides that an organization is substantial in relation to rents if active leasing expenses equal or exceed 25% of adjusted leasing profit. However, the active leasing expenses of FS1 are less than 25% of its adjusted leasing profit, which includes the rental income of FS4 treated as received directly by FS1 as well as the rental income of FS2 treated as received directly by FS1.

(B) *Results*. Because FS2's rental income constitutes non-passive income as a result of the application of § 1.1297–1(c)(1)(i)(A) and section 954(c)(2)(A), it is treated as non-passive income that FS1 is treated as receiving directly under section 1297(c) and paragraph (b)(2) of this section for purposes of determining whether FS1 is a PFIC, and accordingly, it is not necessary to rely on paragraph (e) of this section.

(iii) *Example 3*—(A) *Facts*. The facts are the same as in paragraph (e)(3)(i)(A) of this section (the facts in *Example 1*), except that USP directly owns 60% of the outstanding stock of FS1.

(B) *Results*. Under paragraph (e)(2)(iii) of this section, USP cannot be the common parent of an affiliated group for purposes of paragraph (e)(2) of this section because it is a domestic corporation. Because FS1 is a foreign corporation, FS1 may be the common parent of an affiliated group for purposes of paragraph (e)(2) of this section. The results therefore are the same as in paragraph (e)(3)(i)(B) of this section (the results in Example 1).

(f) *Gain on disposition of a look-through subsidiary or look-through partnership*—(1) [Reserved].

(2) *Amount of gain taken into account from disposition of look-through subsidiary*. For purposes of section 1297(a)(1), section 1298(b)(3), and § 1.1298–2, the amount of gain that is taken into account by a tested foreign corporation from the tested foreign corporation's direct disposition of stock of a look-through subsidiary, or an indirect disposition resulting from the disposition of stock of a look-through subsidiary by other look-through subsidiaries or by look-through partnerships, is the residual gain. The residual gain equals the total gain recognized by the tested foreign corporation (including gain treated as recognized by the tested foreign corporation pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section) from the disposition of the stock of the look-through subsidiary reduced (but not below zero) by unremitted earnings. *Unremitted earnings* are the excess (if any) of the aggregate income (if any) taken into account by the tested foreign corporation pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section with respect to the stock of the disposed-of look-through subsidiary (including with respect to any other look-through subsidiary, to the extent it is owned by the tested foreign corporation indirectly through the disposed-of look-through subsidiary) over the aggregate dividends (if any) received by the tested foreign corporation from the disposed-of look-through subsidiary with respect to the stock, determined without regard to paragraph (c)(2)(i) of this section. For purposes of this paragraph (f)(2), the amount of gain derived from the disposition of stock of a look-through subsidiary and income of and dividends received from the look-through subsidiary is determined on a share-by-share basis under a reasonable method.

(3) *Characterization of residual gain as passive income*. For purposes of section 1297(a)(1), section 1298(b)(3), and § 1.1298–2, the residual gain from the direct or indirect disposition of stock of a look-through subsidiary is characterized as passive income or non-passive income based on the relative amounts of passive assets and non-passive assets

(as defined in § 1.1297–1(f)(5) and (3), respectively) of the disposed-of look-through subsidiary (and any other look-through subsidiary to the extent owned indirectly through the look-through subsidiary) treated as held by the tested foreign corporation on the date of the disposition of the look-through subsidiary. For the purpose of this paragraph (f)(3), the relative amounts of passive assets and non-passive assets held by the look-through subsidiary are measured under the same method (value or adjusted bases) used to measure the assets of the tested foreign corporation for purposes of section 1297(a)(2).

(4) *Gain taken into account from disposition of 25%-owned partnerships and look-through partnerships*—(i) *Section 954(c)(4) partnerships*. The amount of gain derived from a tested foreign corporation's direct or indirect (through a look-through subsidiary or look-through partnership) disposition of partnership interests in a partnership described in section 954(c)(4) (treating the tested foreign corporation as if it were a controlled foreign corporation) that is taken into account by the tested foreign corporation for purposes of section 1297(a)(1), section 1298(b)(3), and § 1.1298–2 is determined under section 954(c)(4).

(ii) *Look-through partnerships*. In the case of a look-through partnership that is not described in paragraph (f)(4)(i) of this section, the principles of paragraphs (f)(2) and (f)(3) of this section apply to determine the amount and characterization of gain derived from a tested foreign corporation's direct or indirect (through a look-through subsidiary or look-through partnership) disposition of partnership interests of the look-through partnership that is taken into account by the tested foreign corporation for purposes of section 1297(a)(1), section 1298(b)(3), and § 1.1298–2.

(5) *Examples*. The following examples illustrate the rules of this paragraph (f). For purposes of the examples in this paragraph (f)(5), USP is a domestic corporation, TFC and FS are foreign corporations that are not controlled foreign corporations within the meaning of section 957(a), and USP, TFC, and FS each has a single class of stock with 100 shares outstanding and a calendar taxable year.

(i) *Example 1*—(A) *Facts*. USP owned 30% of the outstanding stock of TFC throughout Years 1, 2, 3, and 4. In Year 1, TFC purchased 5 shares of FS stock, representing 5% of the stock of FS, from an unrelated person. On the first day of Year 3, TFC purchased 20 shares of FS stock, representing 20% of the stock of FS, from an unrelated person. TFC owned 25% of the outstanding stock of FS throughout Years 3 and 4. Before Year 3, TFC did not include any amount in income with respect to FS under section 1297(c)(2). During Years 3 and 4, for purposes of section 1297(a)(1), TFC included in income, in the aggregate, $40x of income with respect to FS under section 1297(c) and paragraph (b)(2) of this section. TFC did not receive dividends from FS during Year 1, 2, 3, or 4. For purposes of section 1297(a)(2), TFC measures its assets based on their fair market value as provided under section 1297(e). On the last day of Year 4, TFC recognizes a loss with respect to the sale of 5 shares of FS stock, and a $110x gain with respect to the sale of 20 shares of FS stock. On the date of the sale, FS owns non-passive assets with an aggregate fair market value of $150x, and passive assets with an aggregate fair market value of $50x.

(B) *Results*. For purposes of applying section 1297(a)(1) to TFC for Year 4, TFC must take into account $78x of residual gain, as provided by paragraph (f)(2) of this section, which equals the amount by which the $110x gain recognized on the sale of 20 shares in FS exceeds the aggregate pro rata share of $32x income ($40x × 20/25) taken into account by TFC with respect to the 20 shares in FS under section 1297(c) and paragraph (b)(2) of this section during Years 3 and 4. There is zero residual gain on the sale of 5 shares of FS stock because they were sold at a loss. Under paragraph (f)(3) of this section, $58.50x of the residual gain is non-passive income ($78x × ($150x/$200x)) and $19.50x is passive income ($78x × ($50x/$200x)).

(ii) *Example 2*—(A) *Facts*. The facts are the same as in paragraph (f)(5)(i)(A) of this section (the facts in *Example 1*), except that in Year 1, TFC purchased 15 shares of FS stock, representing 15%

of the stock of FS, from an unrelated person, and on the first day of Year 3, TFC purchased an additional 15 shares of FS stock, representing 15% of the stock of FS, from an unrelated person, and on the last day of Year 4, TFC recognizes gain of $10x of the sale of 15 shares of FS stock purchased in Year 1, and gain of $60x on the sale of the other 15 shares of FS stock purchased in Year 3.

(B) *Results*. For purposes of applying section 1297(a)(1) to TFC for Year 4, TFC must take into account $40x of residual gain with respect to the 15 shares acquired in Year 3, as provided by paragraph (f)(2) of this section, which equals the amount by which the $60x gain recognized on the sale of those 15 shares exceeds the aggregate pro rata share of $20x income ($40x × 15/30) taken into account by TFC with respect to those 15 shares in FS under section 1297(c)(2) during Years 3 and 4. There is zero residual gain on the sale of the 15 shares of FS stock acquired in Year 1 because the $10x of gain does not exceed the aggregate pro rata share of $20x income taken into account by TFC with respect to those 15 shares of FS under section 1297(c) and paragraph (b)(2) of this section. Under paragraph (f)(3) of this section, $30x of the residual gain is non-passive income ($40x × ($150x/$200x)) and $10x is passive income ($40x × ($50x/$200x)).

(iii) *Example 3*—(A) *Facts*. The facts are the same as in paragraph (f)(5)(ii)(A) of this section (the facts in *Example 2*), except that TFC received, in the aggregate, $20x of dividends from FS during Year 2.

(B) *Results*. The results are the same as in paragraph (f)(5)(ii)(B) of this section (the results in *Example 2*) with respect to the 15 shares acquired in Year 3 ($40x of residual gain attributable to the 15 shares acquired in Year 3). For purposes of applying section 1297(a)(1) to TFC for Year 4, TFC must also take into account $10x of residual gain with respect to the 15 shares acquired in Year 1. As provided by paragraph (f)(2) of this section, the residual gain equals the amount by which the $10x gain recognized on the sale of those 15 shares exceeds the unremitted earnings with respect to those shares. The unremitted earnings with respect to the 15 shares acquired in Year 1 are $0x, the amount by which the pro rata share of aggregate income ($20x) taken into account by TFC with respect to those 15 shares of FS stock under section 1297(c) and paragraph (b)(2) of this section in Years 3 and 4 exceeds the aggregate pro rata amount of dividends with respect to those 15 shares of FS stock ($20x) received by TFC from FS in Year 2. Total residual gain therefore is $50x ($40x + $10x). Under paragraph (f)(3) of this section, $37.50x of the residual gain is non-passive income ($50x × ($150x/$200x)) and $12.50x is passive income ($50x × ($50x/$200x)).

(g) *Definitions*. The following definitions apply for purposes of § 1.1297–1 and this section:

(1) *Direct LTS obligation*. The term *direct LTS obligation* has the meaning provided in paragraph (c)(1)(ii) of this section.

(2) *Indirect LTS obligation*. The term *indirect LTS obligation* has the meaning provided in paragraph (c)(1)(ii) of this section.

(3) *Look-through subsidiary*. The term *look-through subsidiary* means, with respect to a tested foreign corporation, a corporation as to which the asset test of paragraph (g)(3)(i) and the income test of paragraph (g)(3)(ii) of this section are satisfied on each measuring date during the taxable year of a tested foreign corporation. If a corporation satisfies both the asset test of paragraph (g)(3)(i) and the income test of paragraph (g)(3)(ii)(B) for some but not all measuring periods within the taxable year of a tested foreign corporation, the subsidiary is treated as a look-through subsidiary only for those measuring periods in which both tests are satisfied.

(i) For purposes of section 1297(a)(2) and paragraph (b)(2)(i) of this section, a corporation at least 25 percent of the value of the stock of which is owned (as determined under paragraph (b)(1) of this section) by the tested foreign corporation on the measuring date (as defined in § 1.1297–1(f)(1));

(ii) For purposes of section 1297(a)(1), either—

(A) For the taxable year, a corporation with respect to which the average percentage ownership (which is equal to the percentage ownership (by value)

(as determined under paragraph (b)(1) of this section) on each measuring date during the taxable year, divided by the number of measuring dates in the year) by the tested foreign corporation during the tested foreign corporation's taxable year is at least 25 percent; or

(B) For a measuring period (as defined in § 1.1297–1(f)(2)), a corporation at least 25 percent of the value of the stock of which is owned (as determined under paragraph (b)(1) of this section) by the tested foreign corporation on the measuring date, provided all items of gross income of the corporation for each of the measuring periods in the taxable year for which the tested foreign corporation owns at least 25 percent of the value (as determined under paragraph (b)(1) of this section) on the relevant measuring dates can be established; and

(iii) For purposes of paragraph (f) of this section and § 1.1298–2, a corporation at least 25 percent of the value of the stock of which is owned (as determined under paragraph (b)(1) of this section) by the tested foreign corporation immediately before the disposition of stock of the corporation.

(4) *Look-through partnership*—(i) *In general*. The term *look-through partnership* means, with respect to a tested foreign corporation—

(A) A partnership that would be a look-through subsidiary (as defined in paragraph (g)(3) of this section) if such partnership were a corporation; or

(B) A partnership that is not described in paragraph (g)(4)(i)(A) of this section, if the tested foreign corporation satisfies both of the active partner tests set forth in paragraphs (g)(4)(ii)(A) and (B) of this section on the measurement date or for the taxable year, as applicable, unless an election is made under paragraph (g)(4)(iii) of this section.

(ii) *Active partner test*—(A) *Partnership interest under asset test*. For purposes of paragraph (b)(3)(i) of this section, paragraph (g)(4)(i)(B) of this section applies for the measuring period only if the tested foreign corporation would not be a PFIC if section 1297(a)(1) and (2) and the regulations thereunder were applied to the tested foreign corporation without regard to any partnership interest owned by the tested foreign corporation that is not a partnership described in paragraph (g)(4)(i)(A) of this section. For purposes of the preceding sentence, the active partner test is applied on the measurement date (as defined in § 1.1297–1(f)(1)).

(B) *Partnership income under income test*. For purposes of paragraph (b)(3)(ii) of this section, paragraph (g)(4)(i)(B) of this section applies for the taxable year of the tested foreign corporation or for a measuring period (as defined in § 1.1297–1(f)(2)), as applicable, only if the tested foreign corporation would not be a PFIC if section 1297(a)(1) and (2) and the regulations thereunder were applied to the tested foreign corporation without regard to any partnership interest owned by the tested foreign corporation that is not a partnership described in paragraph (g)(4)(i)(A) of this section. For purposes of the preceding sentence, the active partner test is applied on the measuring date (as defined in § 1.1297–1(f)(1)) or for the taxable year, as applicable using the same period that was used under paragraph (g)(3)(ii) of this section.

(iii) *Election*. For any taxable year, an election may be made with respect to a partnership described in paragraph (g)(4)(i)(B) of this section to not apply the provisions of this paragraph (g)(4) to such partnership.

(iv) *Examples*. The following examples illustrate the rules of this paragraph (g)(4). For purposes of the examples in this paragraph (g)(4)(iv), TFC is a foreign corporation that is not a controlled foreign corporation; FC1 and FC2 are foreign corporations that are not controlled foreign corporations; FPS is a foreign partnership; TFC owns 100% of the single class of stock of FC1 and FC2; FC2 owns 10% of the value of FPS, and the remaining 90% of FPS is owned by an unrelated foreign person; and TFC, FC1, FC2, and FPS are all calendar year taxpayers.

(A) *Example 1*—(*1*) *Facts*. During Year 1, FC1 generated $100x of non-passive income, FC2 generated $150x of non-passive income, and FPS generated $50x of income. On all of the measurement dates in Year 1, FC1 has assets with a value of $1000x that FC1 uses in its trade or business generating non-passive income, FC2 has assets with a value of $1500x that FC2 uses in its

trade or business generating non-passive income, and FPS has assets with a value of $500x.

(*2*) *Results*—(*i*) *Active partner test with respect to partnership interest.* Pursuant to section 1297(c) and §1.1297–2(b)(2), TFC is treated as holding directly the assets held by FC1 and FC2. For purposes of the active partner test under paragraph (g)(4)(ii)(B) of this section, TFC does not take into account its interest in FPS to determine whether it would be a PFIC. Because 100% ($2500x/$2500x) of the assets of FC1 and FC2 that TFC is treated as directly holding, without taking into account the interest in FPS, generates non-passive income, TFC satisfies the active partner test in paragraph (g)(4)(ii)(B) of this section.

(*ii*) *Active partner test with respect to partnership income.* Pursuant to section 1297(c) and paragraph (b)(2) of this section, TFC is treated as if it received directly its proportionate share of income of FC1 and FC2. For purposes of the active partner test under paragraph (g)(4)(ii)(A) of this section, TFC does not take into account its interest in FPS to determine whether it would be a PFIC. Because 100% ($250x/$250x) of the income of FC1 and FC2 that TFC is treated as directly receiving, without taking into account the interest in FPS, is non-passive income, TFC satisfies the active partner test in paragraph (g)(4)(ii)(A) of this section with respect to the income of FPS.

(*iii*) *Qualification of look-through partnership.* For purposes of paragraph (b)(3) of this section, FPS qualifies as a look-through partnership because TFC satisfies the active partner tests of both paragraphs (g)(4)(ii)(A) and (B) of this section. Unless an election is made not to treat FPS as a look-through partnership under paragraph (g)(4)(iii) of this section, TFC is treated as receiving directly $5x of income (10% × $50x), TFC's pro rata share of the income of FPS, the character of which is determined at the level of FPS for purposes of section 1297. In addition, TFC is treated as holding directly $50x of FPS's assets (10% × $500x), TFC's proportionate share of the assets held by FPS. The character of those assets as passive or non-passive is determined in the hands of FPS for purposes of section 1297.

(B) *Example 2*—(*1*) *Facts.* During Year 1, FC1 generated $50x of passive income, FC2 earned $175x of non-passive income, and FPS generated $50x of income. On all of the measurement dates in Year 1, FC1 has assets with a value of $1100x that produce passive income, and FC2 has assets with a value of $900x that FC2 uses in its trade or business generating non-passive income. The value of FPS is $1000x taking into account its assets and liabilities.

(*2*) *Results*—(*i*) *Active partner test with respect to partnership interest.* Pursuant to section 1297(c) and §1.1297–2(b)(2), TFC is treated as holding directly the assets held by FC1 and FC2. For purposes of the active partner test under paragraph (g)(4)(ii)(B) of this section, TFC does not take into account its interest in FPS to determine whether it would be a PFIC. Accordingly, 55% ($1100x/$2000x) of the assets that TFC is treated as directly holding, without taking into account the interest in FPS, generate passive income.

(*ii*) *Active partner test with respect to partnership income.* Pursuant to section 1297(c) and §1.1297–2(b)(2), TFC is treated as if it received directly its proportionate share of income of FC1 and FC2. For purposes of the active partner test under paragraph (g)(4)(ii)(A) of this section, TFC does not take into account its interest in FPS to determine whether it would be a PFIC. Accordingly, 77.8% ($175x/$225x) of the income that TFC is treated as directly receiving, without taking into account the interest in FPS, is non-passive income.

(*iii*) *Failure to qualify as look-through partnership.* TFC satisfies the active partner test in paragraph (g)(4)(ii)(A) of this section but does not satisfy the active partner test in paragraph (g)(4)(ii) (B) of this section. Therefore, FPS does not qualify as a look-though partnership. Under paragraph (b)(3)(iii) of this section, TFC's share of income with respect to FPS is treated as passive income for purposes of section 1297 and TFC's $100x interest (10% × $1000x) in FPS is treated as a passive asset for purposes of section 1297.

(5) *LTS debt*. The term *LTS debt* has the meaning provided in paragraph (c)(1)(ii) of this section.

(6) *LTS lease*. The term *LTS lease* has the meaning provided in paragraph (c)(1)(ii) of this section.

(7) *LTS license*. The term *LTS license* has the meaning provided in paragraph (c)(1)(ii) of this section.

(8) *LTS obligation*. The term *LTS obligation* has the meaning provided in paragraph (c)(1)(ii) of this section.

(9) *LTS stock*. The term *LTS stock* has the meaning provided in paragraph (c)(1)(i) of this section.

(10) *Qualified affiliate*. The term *qualified affiliate* has the meaning provided in paragraph (e)(2) of this section.

(11) *Residual gain*. The term *residual gain* has the meaning provided in paragraph (f)(2) of this section.

(12) *TFC obligation*. The term *TFC obligation* has the meaning provided in paragraph (c)(1)(ii) of this section.

(13) *Unremitted earnings*. The term *unremitted earnings* has the meaning provided in paragraph (f)(2) of this section.

(h) *Applicability date*. The rules of this section apply to taxable years of shareholders beginning on or after January 14, 2021. A shareholder may choose to apply such rules for any open taxable year beginning before January 14, 2021, provided that, with respect to a tested foreign corporation, the shareholder consistently applies the provisions of §1.1291–1(b)(8)(iv) and (b)(8)(v)(A), (B), (C), and (D) and §§1.1297–1 (except that consistent treatment is not required with respect to §1.1297–1(c)(1)(i)(A)), 1.1298–2, and 1.1298–4 for such year and all subsequent years.

[T.D. 9936, 86 FR 4557, Jan. 15, 2021, as amended at 86 FR 13648, Mar. 10, 2021]

§1.1297–3 Deemed sale or deemed dividend election by a U.S. person that is a shareholder of a section 1297(e) PFIC.

(a) *In general*. A shareholder (as defined in §1.1291–9(j)(3)) of a foreign corporation that is a section 1297(e) passive foreign investment company (PFIC) (as defined in §1.1291–9(j)(2)(v)) with respect to such shareholder, shall be treated for tax purposes as holding stock in a PFIC and therefore continues to be subject to taxation under section 1291 unless the shareholder makes a purging election under section 1298(b)(1). A purging election under section 1298(b)(1) is made under rules similar to the rules of section 1291(d)(2). Section 1291(d)(2) allows a shareholder to purge the continuing PFIC taint by either making a deemed sale election or a deemed dividend election.

(b) *Application of deemed sale election rules*—(1) *Eligibility to make the deemed sale election*. A shareholder of a foreign corporation that is a section 1297(e) PFIC with respect to such shareholder may make a deemed sale election under section 1298(b)(1) by applying the rules of this paragraph (b).

(2) *Effect of the deemed sale election*. A shareholder making the deemed sale election with respect to a section 1297(e) PFIC shall be treated as having sold all of its stock in the section 1297(e) PFIC for its fair market value on the controlled foreign corporation (CFC) qualification date, as defined in paragraph (d) of this section. A deemed sale under this section is treated as a disposition subject to taxation under section 1291. Thus, the gain from the deemed sale is taxed as an excess distribution received on the CFC qualification date. In the case of an election made by an indirect shareholder, the amount of gain to be recognized and taxed as an excess distribution is the amount of gain that the direct owner of the stock of the PFIC would have realized on an actual sale or disposition of the stock of the PFIC indirectly owned by the shareholder. Any loss realized on the deemed sale is not recognized. After the deemed sale election, the shareholder's stock with respect to which the election was made under this paragraph (b) shall not be treated as stock in a PFIC and the shareholder shall not be subject to taxation under section 1291 with respect to such stock unless the qualified portion of the shareholder's holding period ends, as determined under section 1297(e)(2), and the foreign corporation thereafter qualifies as a PFIC under section 1297(a).

(3) *Time for making the deemed sale election*. Except as provided in paragraph (e) of this section, a shareholder shall make the deemed sale election under this paragraph (b) and section

1298(b)(1) in the shareholder's original or amended return for the taxable year that includes the CFC qualification date (election year). If the deemed sale election is made in an amended return, the return must be filed by a date that is within three years of the due date, as extended under section 6081, of the original return for the election year.

(4) *Manner of making the deemed sale election.* A shareholder makes the deemed sale election under this paragraph (b) by filing Form 8621, ''Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund'', with the return of the shareholder for the election year, reporting the gain as an excess distribution pursuant to section 1291(a) as if such sale occurred under section 1291(d)(2), and paying the tax and interest due on the excess distribution. A shareholder that makes the deemed sale election after the due date of the return (determined without regard to extensions) for the election year must pay additional interest, pursuant to section 6601, on the amount of underpayment of tax for that year. An electing shareholder that realizes a loss shall report the loss on Form 8621, but shall not recognize the loss.

(5) *Adjustments to basis.* A shareholder that makes the deemed sale election increases its adjusted basis of the PFIC stock owned directly by the amount of gain recognized on the deemed sale. If the shareholder makes the deemed sale election with respect to a PFIC of which it is an indirect shareholder, the shareholder's adjusted basis of the stock or other property owned directly by the shareholder, through which ownership of the PFIC is attributed to the shareholder, is increased by the amount of gain recognized by the shareholder. In addition, solely for purposes of determining the subsequent treatment under the Internal Revenue Code (Code) and regulations of a shareholder of the stock of the PFIC, the adjusted basis of the direct owner of the stock of the PFIC is increased by the amount of gain recognized on the deemed sale. A shareholder shall not adjust the basis of any stock with respect to which the shareholder realized a loss on the deemed sale, which loss is not recognized under paragraph (b)(2) of this section.

(6) *Treatment of holding period.* If a shareholder of a foreign corporation has made a deemed sale election, then, for purposes of applying sections 1291 through 1298 to such shareholder after the deemed sale, the shareholder's holding period in the stock of the foreign corporation begins on the CFC qualification date, without regard to whether the shareholder recognized gain on the deemed sale. For other purposes of the Code and regulations, this holding period rule does not apply.

(c) *Application of deemed dividend election rules*—(1) *Eligibility to make the deemed dividend election.* A shareholder of a foreign corporation that is a section 1297(e) PFIC with respect to such shareholder may make the deemed dividend election under the rules of this paragraph (c). A deemed dividend election may be made by a shareholder whose pro rata share of the post-1986 earnings and profits of the PFIC attributable to the PFIC stock held on the CFC qualification date is zero.

(2) *Effect of the deemed dividend election.* A shareholder making the deemed dividend election with respect to a section 1297(e) PFIC shall include in income as a dividend its pro rata share of the post-1986 earnings and profits of the PFIC attributable to all of the stock it held, directly or indirectly on the CFC qualification date, as defined in paragraph (d) of this section. The deemed dividend is taxed under section 1291 as an excess distribution received on the CFC qualification date. The excess distribution determined under this paragraph (c) is allocated under section 1291(a)(1)(A) only to each day of the shareholder's holding period of the stock during which the foreign corporation qualified as a PFIC. For purposes of the preceding sentence, the shareholder's holding period of the PFIC stock ends on the day before the CFC qualification date. After the deemed dividend election, the shareholder's stock with respect to which the election was made under this paragraph (c) shall not be treated as stock in a PFIC and the shareholder shall not be subject to taxation under section 1291 with respect to such stock unless

the qualified portion of the shareholder's holding period ends, as determined under section 1297(e)(2), and the foreign corporation thereafter qualifies as a PFIC under section 1297(a).

(3) *Post-1986 earnings and profits defined*—(i) *In general*—(A) *General rule.* For purposes of this section, the term post-1986 earnings and profits means the post-1986 undistributed earnings, within the meaning of section 902(c)(1) (determined without regard to section 902(c)(3)), as of the day before the CFC qualification date, that were accumulated and not distributed in taxable years of the PFIC beginning after 1986 and during which it was a PFIC, without regard to whether the earnings related to a period during which the PFIC was a CFC.

(B) *Special rule.* If the CFC qualification date is a day that is after the first day of the taxable year, the term post-1986 earnings and profits means the post-1986 undistributed earnings, within the meaning of section 902(c)(1) (determined without regard to section 902(c)(3)), as of the close of the taxable year that includes the CFC qualification date. For purposes of this computation, only earnings and profits accumulated in taxable years during which the foreign corporation was a PFIC shall be taken into account, but without regard to whether the earnings related to a period during which the PFIC was a CFC.

(ii) *Pro rata share of post-1986 earnings and profits attributable to shareholder's stock*—(A) *In general.* A shareholder's pro rata share of the post-1986 earnings and profits of the PFIC attributable to the stock held by the shareholder on the CFC qualification date is the amount of post-1986 earnings and profits of the PFIC accumulated during any portion of the shareholder's holding period ending at the close of the day before the CFC qualification date and attributable, under the principles of section 1248 and the regulations under that section, to the PFIC stock held on the CFC qualification date.

(B) *Reduction for previously taxed amounts.* A shareholder's pro rata share of the post-1986 earnings and profits of the PFIC does not include any amount that the shareholder demonstrates to the satisfaction of the Commissioner (in the manner provided in paragraph (c)(5)(ii) of this section) was, pursuant to another provision of the law, previously included in the income of the shareholder, or of another U.S. person if the shareholder's holding period of the PFIC stock includes the period during which the stock was held by that other U.S. person.

(4) *Time for making the deemed dividend election.* Except as provided in paragraph (e) of this section, the shareholder shall make the deemed dividend election under this paragraph (c) and section 1298(b)(1) in the shareholder's original or amended return for the taxable year that includes the CFC qualification date (election year). If the deemed dividend election is made in an amended return, the return must be filed by a date that is within three years of the due date, as extended under section 6081, of the original return for the election year.

(5) *Manner of making the deemed dividend election*—(i) *In general.* A shareholder makes the deemed dividend election by filing Form 8621 and the attachment to Form 8621 described in paragraph (c)(5)(ii) of this section with the return of the shareholder for the election year, reporting the deemed dividend as an excess distribution pursuant to section 1291(a)(1), and paying the tax and interest due on the excess distribution. A shareholder that makes the deemed dividend election after the due date of the return (determined without regard to extensions) for the election year must pay additional interest, pursuant to section 6601, on the amount of underpayment of tax for that year.

(ii) *Attachment to Form 8621.* The shareholder must attach a schedule to Form 8621 that demonstrates the calculation of the shareholder's pro rata share of the post-1986 earnings and profits of the PFIC that is treated as distributed to the shareholder on the CFC qualification date, pursuant to this paragraph (c). If the shareholder is claiming an exclusion from its pro rata share of the post-1986 earnings and profits for an amount previously included in its income or the income of another U.S. person, the shareholder must include the following information:

(A) The name, address and taxpayer identification number of each U.S. person that previously included an amount in income, the amount previously included in income by each such U.S. person, the provision of law, pursuant to which the amount was previously included in income, and the taxable year or years of inclusion of each amount.

(B) A description of the transaction pursuant to which the shareholder acquired, directly or indirectly, the stock of the PFIC from another U.S. person, and the provision of law pursuant to which the shareholder's holding period includes the period the other U.S. person held the CFC stock.

(6) *Adjustments to basis.* A shareholder that makes the deemed dividend election increases its adjusted basis of the stock of the PFIC owned directly by the shareholder by the amount of the deemed dividend. If the shareholder makes the deemed dividend election with respect to a PFIC of which it is an indirect shareholder, the shareholder's adjusted basis of the stock or other property owned directly by the shareholder, through which ownership of the PFIC is attributed to the shareholder, is increased by the amount of the deemed dividend. In addition, solely for purposes of determining the subsequent treatment under the Code and regulations of a shareholder of the stock of the PFIC, the adjusted basis of the direct owner of the stock of the PFIC is increased by the amount of the deemed dividend.

(7) *Treatment of holding period.* If the shareholder of a foreign corporation has made a deemed dividend election, then, for purposes of applying sections 1291 through 1298 to such shareholder after the deemed dividend, the shareholder's holding period of the stock of the foreign corporation begins on the CFC qualification date. For other purposes of the Code and regulations, this holding period rule does not apply.

(8) *Coordination with section 959(e).* For purposes of section 959(e), the entire deemed dividend is treated as having been included in gross income under section 1248(a).

(d) *CFC qualification date.* For purposes of this section, the CFC qualification date is the first day on which the qualified portion of the shareholder's holding period in the section 1297(e) PFIC begins, as determined under section 1297(e).

(e) *Late purging elections requiring special consent*—(1) *In general.* This section prescribes the exclusive rules under which a shareholder of a section 1297(e) PFIC may make a section 1298(b)(1) election after the time prescribed in paragraph (b)(3) or (c)(4) of this section for making a deemed sale or a deemed dividend election has elapsed (late purging election). Therefore, a shareholder may not seek such relief under any other provisions of the law, including § 301.9100–3 of this chapter. A shareholder may request the consent of the Commissioner to make a late deemed sale or deemed dividend election for the taxable year of the shareholder that includes the CFC qualification date provided the shareholder satisfies the requirements set forth in this paragraph (e). The Commissioner may, in his discretion, grant relief under this paragraph (e) only if—

(i) In a case where the shareholder is requesting consent under this paragraph (e) after December 31, 2005, the shareholder requests such consent before a representative of the Internal Revenue Service (IRS) raises upon audit the PFIC status of the foreign corporation for any taxable year of the shareholder;

(ii) The shareholder has agreed in a closing agreement with the Commissioner, described in paragraph (e)(3) of this section, to eliminate any prejudice to the interests of the U.S. government, as determined under paragraph (e)(2) of this section, as a consequence of the shareholder's inability to file amended returns for its taxable year in which the CFC qualification date falls or an earlier closed taxable year in which the shareholder has taken a position that is inconsistent with the treatment of the foreign corporation as a PFIC; and

(iii) The shareholder satisfies the procedural requirements set forth in paragraph (e)(3) of this section.

(2) *Prejudice to the interests of the U.S. government.* The interests of the U.S. government are prejudiced if granting relief would result in the shareholder having a lower tax liability (other than

by a de minimis amount), taking into account applicable interest charges, for the taxable year that includes the CFC qualification date (or a prior taxable year in which the taxpayer took a position on a return that was inconsistent with the treatment of the foreign corporation as a PFIC) than the shareholder would have had if the shareholder had properly made the section 1298(b)(1) election in the time prescribed in paragraph (b)(2) or (c)(3) of this section (or had not taken a position in a return for an earlier year that was inconsistent with the status of the foreign corporation as a PFIC). The time value of money is taken into account for purposes of this computation.

(3) *Procedural requirements*—(i) *In general*. The amount due with respect to a late purging election is determined in the same manner as if the purging election had been timely filed. However, the shareholder is also liable for interest on the amount due, pursuant to section 6601, determined for the period beginning on the due date (without extensions) for the taxpayer's income tax return for the year in which the CFC qualification date falls and ending on the date the late purging election is filed with the IRS.

(ii) *Filing instructions*. A late purging election is made by filing a completed Form 8621–A, ''Return by a Shareholder Making Certain Late Elections to End Treatment as a Passive Foreign Investment Company.''

(4) *Time and manner of making late election*—(i) *Time for making a late purging election*. A shareholder may make a late purging election in the manner provided in paragraph (e)(4)(ii) of this section at any time. The date the election is filed with the IRS will determine the amount of interest due under paragraph (e)(3) of this section.

(ii) *Manner of making a late purging election*. A shareholder makes a late purging election by completing Form 8621–A in the manner required by that form and this section and filing that form with the Internal Revenue Service, DP 8621–A, Ogden, UT 84201.

(5) *Multiple late elections*—(i) *General rule*. A shareholder of a foreign corporation may make multiple late purging elections under the rules of this paragraph (e) or § 1.1298–3(e) to the same extent such multiple purging elections could have been made if those purging elections had been filed within the time prescribed under paragraph (b)(3) or (c)(4) of this section or § 1.1298–3(b)(3) or (c)(4).

(ii) *Example*. The rule of this paragraph (e)(5) is illustrated by the following example:

Example. (i) In 1991, X, a U.S. person, acquired a five percent interest in the stock of FC, a controlled foreign corporation, as defined in section 957(a). In years 1991, 1992, 1995, 1996 and 1997, FC satisfied either the income test or the asset test of section 1297(a). X did not make a QEF election with regard to FC. In years 1993 and 1994, FC did not satisfy either the income or the asset test of section 1297(a). In 1998, X acquired additional stock in FC such that X was a U.S. shareholder (as defined in section 951(b)) of FC.

(ii) Because FC qualified as a PFIC in 1991, FC will be treated as a PFIC with respect to all of the stock held by X, under the ''once a PFIC always a PFIC'' rule of section 1298(b)(1), unless X makes an election to purge the PFIC taint. Because X ceased to satisfy either the income or asset test in 1993, X could have made an election under § 1.1298–3 to purge the PFIC taint of FC for that year if X had filed such an election within the time prescribed under § 1.1298–3(b)(3) or (c)(4). If X had done so, the stock X held in FC would not be treated as stock in a PFIC for the years 1993 and 1994. Because X became a U.S. shareholder of FC in 1998, X then could have made a deemed sale or deemed dividend election under this section to purge the PFIC taint of FC for the years 1995 through 1997 if X had filed within the time prescribed under paragraph (b)(3) or (c)(4) of this section. Accordingly, X may make a late purging election to purge the PFIC taint of FC for the years 1991 and 1992 under the rules of § 1.1298–3(e) and may also make a late purging election to purge the PFIC taint of FC for the years 1995 through 1997 under the rules of this paragraph (e).

(f) *Effective/applicability date*. The rules of this section are applicable as of December 8, 2005.

[T.D. 9360, 72 FR 54821, Sept. 27, 2007, as amended at 72 FR 58758, Oct. 17, 2007]

§ 1.1297–4 Qualifying insurance corporation.

(a) *Scope*. This section provides rules for determining whether a foreign corporation is a qualifying insurance corporation for purposes of section 1297(f). Paragraph (b) of this section provides the general rule for determining

whether a foreign corporation is a qualifying insurance corporation. Paragraph (c) of this section describes the 25 percent test in section 1297(f)(1)(B). Paragraph (d) of this section contains rules for applying the alternative facts and circumstances test in section 1297(f)(2). Paragraph (e) of this section contains rules limiting the amount of applicable insurance liabilities for purposes of the 25 percent test described in paragraph (c) of this section and the alternative facts and circumstances test described in paragraph (d) of this section. Paragraph (f) of this section provides definitions that apply for purposes of this section. Paragraph (g) of this section provides the applicability date of this section.

(b) *Qualifying insurance corporation.* For purposes of section 1297(b)(2)(B), this section, and §§ 1.1297–5 and 1.1297–6, with respect to a U.S. person, a qualifying insurance corporation (QIC) is a foreign corporation that—

(1) Is an insurance company as defined in section 816(a) that would be subject to tax under subchapter L if the corporation were a domestic corporation; and

(2) Satisfies—

(i) The 25 percent test described in paragraph (c) of this section; or

(ii) The requirements for an election to apply the alternative facts and circumstances test as described in paragraph (d) of this section and a United States person has made an election as described in paragraph (d)(5) of this section.

(c) *25 percent test.* A foreign corporation satisfies the 25 percent test if the amount of its applicable insurance liabilities exceeds 25 percent of its total assets. This determination is made on the basis of the applicable insurance liabilities and total assets reported on the corporation's applicable financial statement for the applicable reporting period.

(d) *Election to apply the alternative facts and circumstances test*—(1) *In general.* A United States person that owns stock in a foreign corporation that fails to qualify as a QIC solely because of the 25 percent test may elect to treat the stock of the corporation as stock of a QIC if the foreign corporation—

(i) Is predominantly engaged in an insurance business as described in paragraph (d)(2) of this section;

(ii) Failed to satisfy the 25 percent test solely due to runoff-related circumstances, as described in paragraph (d)(3) of this section, or rating-related circumstances, as described in paragraph (d)(4) of this section; and

(iii) Reports an amount of applicable insurance liabilities that is at least 10 percent of the amount of the total assets on the corporation's applicable financial statement for the applicable reporting period.

(2) *Predominantly engaged in an insurance business*—(i) *In general.* A foreign corporation is not considered predominantly engaged in an insurance business in any taxable year unless more than half of the business of the foreign corporation is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. This determination is made based on the character of the business actually conducted in the taxable year. The fact that a foreign corporation has been holding itself out as an insurer for a long period is not determinative of whether the foreign corporation is predominantly engaged in an insurance business.

(ii) *Facts and circumstances.* Facts and circumstances to consider in determining whether a foreign corporation is predominantly engaged in an insurance business include (but are not limited to)—

(A) Claims payment patterns for the current year and prior years;

(B) The foreign corporation's loss exposure as calculated for a regulator or for a credit rating agency, or, if those are not calculated, for internal pricing purposes;

(C) The percentage of gross receipts constituting premiums for the current and prior years; and

(D) The number and size of insurance contracts issued or taken on through reinsurance by the foreign corporation.

(iii) *Examples of facts indicating a foreign corporation is not predominantly engaged in an insurance business.* Examples of facts that may indicate a foreign corporation is not predominantly engaged in an insurance business include (but are not limited to)—

(A) A small overall number of insured risks with low likelihood but large potential costs;

(B) Employees and agents of the foreign corporation focused to a greater degree on investment activities than underwriting activities; and

(C) Low loss exposure.

(3) *Runoff-related circumstances.* During the annual reporting period covered by the applicable financial statement, a foreign corporation fails to satisfy the 25 percent test solely due to runoff-related circumstances only if the corporation—

(i) Was engaged in the process of terminating its pre-existing, active conduct of an insurance business (within the meaning of section 1297(b)(2)(B)) under the supervision of its applicable insurance regulatory body or pursuant to any court-ordered receivership proceeding (liquidation, rehabilitation, or conservation) and fails to satisfy the 25 percent test because the corporation is required to hold additional assets due to its business being in runoff;

(ii) Has no plan or intention to enter into, and did not issue or enter into, any insurance, annuity, or reinsurance contract, other than a contractually obligated renewal of an existing insurance contract or a reinsurance contract pursuant to and consistent with the termination of its active conduct of an insurance business; and

(iii) Made payments during the annual reporting period covered by the applicable financial statement as required to satisfy claims under insurance, annuity, or reinsurance contracts.

(4) *Rating-related circumstances.* A foreign corporation fails to satisfy the 25 percent test solely due to rating-related circumstances only if—

(i) The 25 percent test is not met due to capital and surplus amounts that a generally recognized credit rating agency considers necessary for the foreign corporation to obtain a public rating with respect to its financial strength, and the foreign corporation maintains such capital and surplus in order to obtain the minimum credit rating necessary for the annual reporting period by the foreign corporation to be able to write the business in its regulatory or board supervised business plan. This paragraph (c)(4)(i) applies only if the foreign corporation is a mortgage insurance company (as defined in paragraph (f)(10) of this section) or if more than half of the foreign corporation's net written premiums for the annual reporting period (or the average of the net written premiums for the foreign corporation's annual reporting period and the two immediately preceding annual reporting periods) are from insurance coverage against the risk of loss from a catastrophic loss event (that is, a low frequency but high severity loss event); or

(ii) The foreign corporation is a financial guaranty insurance company (as defined in paragraph (f)(5) of this section).

(5) *Election*—(i) *In general.* A United States person may make the election under section 1297(f)(2) for its taxable year if the foreign corporation directly provides the United States person a statement, signed by a responsible officer of the foreign corporation or an authorized representative of the foreign corporation, or the foreign corporation (or its foreign parent corporation on its behalf) makes a publicly available statement (such as in a public filing, disclosure statement, or other notice provided to United States persons that are shareholders of the foreign corporation) that it satisfied the requirements of section 1297(f)(2) and paragraph (d)(1) of this section during the foreign corporation's applicable reporting period. However, a United States person may not rely upon any statement by the foreign corporation (or its foreign parent corporation) to make the election under section 1297(f)(2) if the shareholder knows or has reason to know based on reasonably accessible information that the statement made by the foreign corporation (or its foreign parent corporation) was incorrect.

(ii) *Information provided by foreign corporation.* In addition to a statement that the foreign corporation satisfied the requirements of section 1297(f)(2) and paragraph (d)(1) of this section, the statement described in paragraph (d)(5)(i) of this section also must include:

(A) The ratio of applicable insurance liabilities to total assets for the applicable reporting period; and

(B) A statement indicating whether the failure to satisfy the 25 percent test described in paragraph (c) of this section was the result of runoff-related or rating-related circumstances, along with a brief description of those circumstances.

(iii) *Time and manner for making the election.* Except as provided in paragraph (d)(5)(iv), the election described in paragraph (d)(1) of this section may be made by a United States person who owns stock in the foreign corporation by completing the appropriate part of Form 8621 (or successor form) for each taxable year of the United States person in which the election applies. A United States person must attach the Form 8621 (or successor form) to its original or amended Federal income tax return for the taxable year of the United States person to which the election relates. A United States person can attach the Form 8621 (or successor form) to an amended return for the taxable year of the United States person to which the election relates if the United States person can demonstrate the reason for not filing the form with its original return was due to reasonable cause.

(iv) *Deemed election for small shareholders in publicly traded companies*—(A) *In general.* A United States person who owns publicly traded stock in a foreign corporation will be deemed to make the election under section 1297(f)(2) with respect to the foreign corporation and its subsidiaries if the following requirements are satisfied:

(*1*) The stock of the foreign corporation that is owned by the United States person (including stock owned indirectly) has a value of $25,000 or less ($50,000 or less in the case of a joint return) on the last day of the United States person's taxable year and on any day during the taxable year on which the United States person disposes of stock of the foreign corporation; and

(*2*) If the United States person owns stock of the foreign corporation indirectly through a domestic partnership, domestic trust, domestic estate, or S corporation (a *domestic pass-through entity*), the stock of the foreign corporation that is owned by the domestic pass-through entity has a value of $25,000 or less on the last day of the taxable year of the domestic pass-through entity that ends with or within the United States person's taxable year and on any day during the taxable year of the domestic pass-through entity on which it disposes of stock of the foreign corporation.

(B) *Publicly traded stock.* For the purpose of paragraph (d)(5)(iv)(A) of this section, stock is publicly traded if it would be treated as marketable stock within the meaning of section 1296(e) and § 1.1296–2 (without regard to § 1.1296–2(d)) if the election under section 1297(f)(2) is not made.

(v) *Options.* If a United States person is considered to own stock in a foreign corporation by reason of holding an option, the United States person may make the election under section 1297(f)(2) (or may be deemed to make an election under paragraph (d)(5)(iv) of this section) with respect to the foreign corporation or its subsidiaries in the same manner as if the United States person owned stock in the foreign corporation.

(6) *Stock ownership.* For purposes of this section, ownership of stock in a foreign corporation means either direct ownership of such stock or indirect ownership determined using the rules specified in § 1.1291–1(b)(8) (but without regard to the 50 percent ownership requirement of § 1.1291–1(b)(8)(ii)(A)).

(e) *Rules limiting the amount of applicable insurance liabilities*—(1) *In general.* For purposes of determining whether a foreign corporation satisfies the 25 percent test described in paragraph (c) of this section or the 10 percent test described in paragraph (d)(1)(iii) of this section, the rules of this paragraph (e) apply to limit the amount of applicable insurance liabilities of the foreign corporation.

(2) *General limitation on applicable insurance liabilities.* The amount of applicable insurance liabilities may not exceed any of the amounts described in paragraphs (e)(2)(i) to (iii) of this section. This paragraph (e)(2) applies after applying paragraph (e)(3) of this section.

(i) The amount of applicable insurance liabilities of the foreign corporation shown on any financial statement that the foreign corporation filed or

was required to file with its applicable insurance regulatory body for the financial statement's applicable reporting period;

(ii) If the foreign corporation's applicable financial statement is prepared on the basis of either GAAP or IFRS, the amount of the foreign corporation's applicable insurance liabilities determined on the basis of its applicable financial statement, whether or not the foreign corporation files the statement with its applicable insurance regulatory body; or

(iii) The amount of applicable insurance liabilities required for the foreign corporation by the applicable law or regulation of the jurisdiction of the applicable insurance regulatory body at the end of the applicable reporting period (or a lesser amount of applicable insurance liabilities, if the foreign corporation is holding a lesser amount as a permitted practice of the applicable regulatory body).

(3) *Discounting*. If an applicable financial statement or a financial statement described in paragraph (e)(2) of this section is prepared on the basis of an accounting method other than GAAP or IFRS and does not discount applicable insurance liabilities on an economically reasonable basis, the amount of applicable insurance liabilities may not exceed the amount of applicable insurance liabilities on the financial statement reduced by applying the discounting methods that would apply under either GAAP or IFRS to the insurance or annuity contracts to which the applicable insurance liabilities at issue relate. The foreign corporation may choose whether to apply either GAAP or IFRS discounting methods for this purpose.

(4) [Reserved]

(5) [Reserved]

(f) *Definitions*. The following definitions apply for purposes of this section.

(1) *Applicable financial statement*. The term *applicable financial statement* means the foreign corporation's financial statement prepared for financial reporting purposes, listed in paragraphs (f)(1)(i) through (iii) of this section, and that has the highest priority. The financial statements are, in order of descending priority—

(i) *GAAP statements*. A financial statement that is prepared in accordance with GAAP;

(ii) *IFRS statements*. A financial statement that is prepared in accordance with IFRS; or

(iii) *Regulatory annual statement*. A financial statement required to be filed with the applicable insurance regulatory body.

(iv) [Reserved]

(2) *Applicable insurance liabilities*—(i) *In general*. The term *applicable insurance liabilities* means, with respect to any life or property and casualty insurance business—

(A) Reported losses (which are expected payments to policyholders for sustained losses related to insured events under an insurance contract that have occurred and have been reported to, but not paid by, the insurer as of the financial statement end date), and incurred but not reported losses (which are expected payments to policyholders for sustained losses relating to insured events under an insurance contract that have occurred but have not been reported to the insurer as of the financial statement end date);

(B) Unpaid loss adjustment expenses (including reasonable estimates of anticipated loss adjustment expenses) associated with investigating, defending, settling, and adjusting paid losses, unpaid reported losses, and incurred but not reported losses (of the type described in paragraph (f)(2)(i)(A) of this section) as of the financial statement end date; and

(C) The aggregate amount of reserves (excluding deficiency, contingency, or unearned premium reserves) held as of the financial statement end date to mature or liquidate potential, future claims for death, annuity, or health benefits that may become payable under contracts providing, at the time the reserve is computed, coverage for mortality or morbidity risks;

(D) Provided, however, that—

(*1*) No item or amount shall be taken into account more than once in determining applicable insurance liabilities;

(*2*) The applicable insurance liabilities eligible to be taken into account in applying this paragraph (f)(2) include only the applicable insurance liabilities of the foreign corporation

whose QIC status is being determined; and

(*3*) [Reserved]

(ii) *Amounts not specified in paragraph (f)(2)(i) of this section*. Amounts not specified in paragraph (f)(2)(i) of this section are not applicable insurance liabilities. For example, the term applicable insurance liability does not include any amount held by an insurance company as a deposit liability that is not an insurance liability, such as a funding agreement, a guaranteed investment contract, premium or other deposit funds, structured settlements, or any other substantially similar contract issued by an insurance company. The term applicable insurance liabilities also does not include the amount of any reserve for a life insurance or annuity contract the payments of which do not depend on the life or life expectancy of one or more individuals.

(3) *Applicable insurance regulatory body*. The term *applicable insurance regulatory body* means the entity that has been established by law to license or authorize a corporation to engage in an insurance business, to regulate insurance company solvency, and, in the case of an applicable financial statement described in paragraph (f)(1)(iii), is the entity to which the applicable financial statement is provided.

(4) *Applicable reporting period*. The term *applicable reporting period* is the last annual reporting period for a financial statement ending with or within the taxable year of a U.S. person owning stock in a foreign corporation, within the meaning of paragraph (d)(6) of this section.

(5) *Financial guaranty insurance company*. The term *financial guaranty insurance company* means any insurance company whose sole business is to insure or reinsure only the type of business written by, or that would be permitted to be written by, a company licensed under, and compliant with, a U.S. state law, modeled after the Financial Guaranty Insurance Guideline as established by National Association of Insurance Companies, that specifically governs the licensing and regulation of financial guaranty insurance companies.

(6) *Financial statements*—(i) *In general*. The term *financial statement* means a statement prepared for a legal entity for a reporting period in accordance with the rules of a financial accounting or statutory accounting standard that includes a complete balance sheet, statement of income, and a statement of cash flows (or equivalent statements under the applicable reporting standard).

(ii) [Reserved]

(iii) [Reserved]

(7) *Generally accepted accounting principles or GAAP*. The term *generally accepted accounting principles* or *GAAP* means United States generally accepted accounting principles described in standards established and made effective by the Financial Accounting Standards Board.

(8) *Insurance business*. For purposes of this section, § 1.1297–5, and § 1.1297–6, *insurance business* means the business of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with those investment activities and administrative services that are required to support (or are substantially related to) insurance, annuity, or reinsurance contracts issued or entered into by the foreign corporation.

(9) *International financial reporting standards* or *IFRS*. The term *international financial reporting standards* or *IFRS* means accounting standards established and made effective by the International Accounting Standards Board.

(10) *Mortgage insurance company*. For purposes of this section, *mortgage insurance company* means any insurance company whose sole business is to insure or reinsure against a lender's loss of all or a portion of the principal amount of a mortgage loan upon default of the mortgagor.

(11) *Total assets*. For purposes of section 1297(f) and this section, a foreign corporation's *total assets* are theaggregate value of the real property and personal property that the foreign corporation reports on its applicable financial statement as of thefinancial statement end date.

(g) *Applicability date*. The rules of this section apply to taxable years of shareholders beginning on or after January 14, 2021. A shareholder may choose to apply such rules for any open taxable

year beginning after December 31, 2017 and before January 14, 2021, provided that, with respect to a tested foreign corporation, it consistently applies the provisions of this section and § 1.1297–6 for such year and all subsequent years.

[T.D. 9936, 86 FR 4571, Jan. 15, 2021, as amended at 86 FR 13648, Mar. 10, 2021]

§ 1.1297–5 [Reserved]

§ 1.1297–6 Exception from the definition of passive income for active insurance income.

(a) *Scope*. This section provides rules pertaining to the exception from passive income under section 1297(b)(2)(B) for income derived in the active conduct of an insurance business and rules related to certain income of a qualifying domestic insurance corporation. Paragraph (b) of this section provides a general rule that excludes from passive income certain income of a qualifying insurance corporation (QIC), as defined in § 1.1297–4(b), and certain income of a qualifying domestic insurance corporation. Paragraph (c) of this section provides rules excluding certain assets for purposes of the passive asset test under section 1297(a)(2). Paragraph (d) of this section provides rules concerning the treatment of income and assets of certain look-through subsidiaries and look-through partnerships of a QIC. Paragraph (e) of this section provides rules relating to qualifying domestic insurance corporations. Paragraph (f) of this section provides the applicability date of this section.

(b) *Exclusion from passive income of active insurance income*. For purposes of section 1297 and § 1.1297–1, passive income does not include—

(1) Income that a QIC derives in the active conduct of an insurance business (within the meaning of section 1297(b)(2)(B)); and

(2) Income of a qualifying domestic insurance corporation.

(c) *Exclusion of assets for purposes of the passive asset test under section 1297(a)(2)*. For purposes of section 1297 and § 1.1297–1, passive assets (as defined in § 1.1297–1(f)(5)), do not include—

(1) Assets of a QIC available to satisfy liabilities of the QIC related to its insurance business (as defined in § 1.1297–4(f)(8)), if the QIC is engaged in the active conduct of an insurance business (within the meaning of section 1297(b)(2)(B)); and

(2) Assets of a qualifying domestic insurance corporation.

(d) *Treatment of income and assets of certain look-through subsidiaries and look-through partnerships for purposes of the section 1297(b)(2)(B) exception*—(1) *General rule*. For purposes of applying paragraphs (b)(1) and (c)(1) of this section, a QIC is treated as receiving the income or holding the assets of a look-through subsidiary or look-through partnership to the extent provided in section 1297(c) and § 1.1297–2(b)(2) or § 1.1297–2(b)(3). Subject to the limitation of paragraph (d)(2) of this section, a QIC's proportionate share of the income or assets of a look-through subsidiary or look-through partnership may be treated as earned or held directly by the QIC, and thus as non-passive under paragraphs (b)(1) and (c)(1) of this section, if the requirements of those paragraphs are satisfied.

(2) *Limitation*. A QIC that is engaged in the active conduct of an insurance business (within the meaning of section 1297(b)(2)(B)) may not treat its proportionate share of the income or assets of a look-through subsidiary or look-through partnership as non-passive to the extent that it exceeds the greater of—

(i) The QIC's proportionate share of the income or assets, respectively, of the look-through subsidiary or look-through partnership multiplied by a fraction, the numerator of which is the net equity value of the interests held by the QIC in the look-through subsidiary or look-through partnership, and the denominator of which is the value of the QIC's proportionate share of the assets of the look-through subsidiary or look-through partnership; and

(ii) The QIC's proportionate share of the income or assets, respectively, of the look-through subsidiary or look-through partnership that are treated as non-passive in the hands of the look-through subsidiary or look-through partnership.

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

(i) *Example 1: QIC holds all the stock of an investment subsidiary*—(A) *Facts*.

(*1*) F1 is a foreign corporation. In Year 1, F1 meets the definition of a QIC under section 1297(f) and § 1.1297–4 and is engaged in the active conduct of an insurance business within the meaning of section 1297(b)(2)(B). Throughout Year 1, F1 owns all the stock of F2, a foreign corporation that is not a QIC and is engaged solely in the investment of passive assets. The stock of F2 is an asset that is available to satisfy liabilities of F1 related to its insurance business within the meaning of paragraph (c)(1) of this section. The assets of F1 are measured on the basis of value under § 1.1297–1(d)(1)(v)(C).

(*2*) Throughout Year 1, F2 owns assets with a value of $1,000x and adjusted bases of $500x, all of which are treated as passive in the hands of F2. F2 has outstanding debt with a principal amount of $250x. On the financial statement end date of F1's applicable financial statement, the net equity value of the F2 stock held by F1 is $750x. In Year 1, F2 earned $100x of income that is treated as passive in the hands of F2.

(B) *Result*—(*1*) Because F1 owns all of the stock of F2, F2 is a look-through subsidiary of F1 within the meaning of § 1.1297–2(g)(3). Under section 1297(c) and § 1.1297–2(b)(2), F1 is treated as if it held 100% of the assets of F2 and received directly 100% of the income of F2. Under paragraph (d)(1) of this section, because F1 is engaged in the active conduct of an insurance business and the stock of F2 is an asset that is available to satisfy the insurance liabilities of F1, F1 treats its proportionate share of the income and assets of F2 as non-passive. The amount of income and assets that is treated as non-passive is subject to the limitation of paragraph (d)(2) of this section.

(*2*) Under paragraph (d)(2) of this section, the amount of F1's proportionate share of F2's income that is treated as non-passive cannot exceed the greater of two amounts: $75x, which is F1's proportionate share of F2's income ($100x) multiplied by 75% (the net equity value of the F2 stock held by F1, which is $750x, divided by the value of F1's proportionate share of F2's assets, which is $1,000x); and zero, which is F1's proportionate share of the income of F2 that is treated as non-passive in the hands of F2. Therefore, for the purpose of characterizing F1's proportionate share of F2's income, $75x is treated as non-passive, and $25x is treated as passive.

(*3*) Under paragraph (d)(2) of this section, the amount of F1's proportionate share of F2's assets that is treated as non-passive cannot exceed the greater of two amounts: $750x, which is F1's proportionate share of F2's assets ($1,000x) multiplied by 75% (the net equity value of the F2 stock held by F1, which is $750x, divided by the value of F1's proportionate share of F2's assets, which is $1,000x); and zero, which is F1's proportionate share of the assets of F2 that are treated as non-passive in the hands of F2. Therefore, for the purpose of characterizing F1's proportionate share of the assets of F2, $750x is treated as non-passive, and $250x is treated as passive.

(C) *Alternative facts*—(*1*) *Facts*. The facts are the same as in paragraph (d)(3)(i)(A) of this section (paragraph (A) of this Example 1), except that the assets of F1 are measured on the basis of adjusted basis under § 1.1297–1(d)(1)(v)(C) pursuant to a valid election under § 1.1297–1(d)(1)(iii).

(*2*) *Result*. The result with respect to F1's proportionate share of the income of F2 is the same as in paragraph (d)(3)(i)(B)(*2*) of this section (paragraph (B)(*2*) of this Example 1). Because the assets of F1 are measured on the basis of adjusted basis under § 1.1297–1(d)(1)(v)(C), F1's proportionate share of the passive assets of F2 is equal to $500x (100% of $500x adjusted bases). Under paragraph (d)(2) of this section, the amount of F1's proportionate share of F2's assets that may be treated as non-passive cannot exceed the greater of two amounts: $375x, which is F1's proportionate share of F2's passive assets ($500x) multiplied by 75% (the net equity value of the F2 stock held by F1, which is $750x, divided by the value of F1's proportionate share of F2's assets, which is $1,000x); and zero, which is F1's proportionate share of the assets of F2 that are treated as non-passive in the hands of F2. Therefore, for the purpose of characterizing F1's proportionate share of the assets of F2, $375x is treated as non-passive, and $125x is treated as passive.

(ii) *Example 2: QIC holds all the stock of an operating subsidiary*—(A) *Facts.*

(*1*) F1 is a foreign corporation. In Year 1, F1 meets the definition of a QIC under section 1297(f) and § 1.1297–4 and is engaged in the active conduct of an insurance business within the meaning of section 1297(b)(2)(B). Throughout Year 1, F1 owns all the stock of F2, a foreign corporation engaged in a manufacturing business that is not a QIC. The stock of F2 is an asset that is available to satisfy liabilities of F1 related to its insurance business within the meaning of paragraph (c)(1) of this section. The assets of F1 are measured on the basis of value under § 1.1297–1(d)(1)(v)(C).

(*2*) Throughout Year 1, F2 owns assets with a value of $1,200x, of which $1,000x is treated as non-passive and $200x is treated as passive in the hands of F2. F2 has outstanding debt of $600x. On the financial statement end date of F1's applicable financial statement, the net equity value of the F2 stock held by F1 is $600x. In Year 1, F2 earned $120x of income, of which, in the hands of F2, $100x is treated as non-passive and $20x is treated as passive.

(B) *Result*—(*1*) Because F1 owns all the stock of F2, F2 is a look-through subsidiary of F1 within the meaning of § 1.1297–2(g)(3). Under section 1297(c) and § 1.1297–2(b)(2), F1 is treated as if it held 100% of the assets of F2 and received directly 100% of the income of F2. Under paragraph (d)(1) of this section, because F1 is engaged in the active conduct of an insurance business and the stock of F2 is an asset that is available to satisfy the insurance liabilities of F1, F1 treats its proportionate share of the income and assets of F2 as non-passive. The amount of income and assets that is treated as non-passive is subject to the limitation of paragraph (d)(2) of this section.

(*2*) Under paragraph (d)(2) of this section, the amount of F1's proportionate share of F2's income that is treated as non-passive cannot exceed the greater of two amounts: $60x, which is F1's proportionate share of F2's income ($120x) multiplied by 50% (the net equity value of the F2 stock held by F1, which is $600x, divided by the value of F1's proportionate share of F2's assets, which is $1,200x); and $100x, which is F1's proportionate share of the income of F2 that is treated as non-passive in the hands of F2. Therefore, for the purpose of characterizing F1's proportionate share of F2's income, $100x is treated as non-passive, and $20x is treated as passive.

(*3*) Under paragraph (d)(2) of this section, the amount of F1's proportionate share of F2's assets that is treated as non-passive cannot exceed the greater of two amounts: $600x, which is F1's proportionate share of F2's income ($1,200x) multiplied by 50% (the net equity value of the F2 stock held by F1, which is $600x, divided by the value of F1's proportionate share of F2's assets, which is $1,200x); and $1,000x, which is F1's proportionate share of the assets of F2 that are treated as non-passive in the hands of F2. Therefore, for the purpose of characterizing F1's proportionate share of the assets of F2, $1,000x is treated as non-passive, and $200x is treated as passive.

(e) *Qualifying domestic insurance corporation*—(1) *General rule.* A domestic corporation (or a foreign corporation that is treated as a domestic corporation pursuant to a valid section 953(d) election and that computes its reserves as a domestic insurance company would under subchapter L) is a qualifying domestic insurance corporation if it is—

(i) Subject to tax as an insurance company under subchapter L of the Internal Revenue Code;

(ii) Subject to federal income tax on its net income; and

(iii) A look-through subsidiary of a tested foreign corporation.

(2) [Reserved]

(3) [Reserved]

(f) *Applicability date.* The rules of this section apply to taxable years of shareholders beginning on or after January 14, 2021. A shareholder may choose to apply such rules for any open taxable year beginning after December 31, 2017 and before January 14, 2021, provided that, with respect to a tested foreign corporation, it consistently applies the provisions of this section and § 1.1297–4, for such year and all subsequent years.

[T.D. 9936, 86 FR 4571, Jan. 15, 2021]

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[T.D. 9360, 72 FR 54824, Sept. 27, 2007, as amended by T.D. 9806, 81 FR 95466, Dec. 28, 2016; T.D. 9936, 86 FR 4576, Jan. 15, 2021]

§ 1.1298–1 Section 1298(f) annual reporting requirements for United States persons that are shareholders of a passive foreign investment company.

(a) *Overview*. This section provides rules regarding the reporting requirements under section 1298(f) applicable to a United States person that is a shareholder (as defined in § 1.1291–1(b)(7)) of a passive foreign investment company (PFIC). Paragraph (b) of this section provides the section 1298(f) annual reporting requirements generally applicable to United States persons. Paragraph (c) of this section sets forth exceptions to reporting for certain shareholders. Paragraph (d) of this section provides rules regarding the time and manner of filing the annual report. Paragraph (e) of this section sets forth the requirement to file a separate annual report with respect to each PFIC. Paragraph (f) of this section coordinates the requirement to file an annual report under section 1298(f) with the requirement to file an annual report under other provisions of the Internal Revenue Code (Code). Paragraph (g) of this section sets forth examples illustrating the application of this section. Paragraph (h) of this section provides effective/applicability dates.

(b) *Requirement to file*—(1) *General rule*. Except as otherwise provided in this section, a United States person that is a shareholder of a PFIC must complete and file Form 8621, ''Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund'' (or successor form), under section 1298(f) and these regulations for the PFIC if, during the shareholder's taxable year, the shareholder—

(i) Directly owns stock of the PFIC;

(ii) Is an indirect shareholder under § 1.1291–1(b)(8) that holds any interest in the PFIC through one or more entities, each of which is foreign; or

(iii) Is an indirect shareholder under § 1.1291–1(b)(8)(iii)(D) that is treated under sections 671 through 678 as the owner of any portion of a trust described in section 7701(a)(30)(E) that owns, directly or indirectly through one or more entities, each of which is foreign, any interest in the PFIC.

(2) *Additional requirement to file for certain indirect shareholders*—(i) *General rule*. Except as otherwise provided in this section, an indirect shareholder that owns an interest in a PFIC through one or more United States persons also must file Form 8621 (or successor form) with respect to the PFIC under section 1298(f) and these regulations if, during the indirect shareholder's taxable year, the indirect shareholder is—

(A) Treated as receiving an excess distribution (within the meaning of section 1291(b)) with respect to the PFIC;

(B) Treated as recognizing gain that is treated as an excess distribution (under section 1291(a)(2)) as a result of a disposition of the PFIC;

(C) Required to include an amount in income under section 1293(a) with respect to the PFIC (QEF inclusion);

(D) Required to include or deduct an amount under section 1296(a) with respect to the PFIC (MTM inclusion); or

(E) Required to report the status of a section 1294 election with respect to the PFIC (see § 1.1294–1T(h)).

(ii) *Exception to indirect shareholder reporting for certain QEF inclusions and MTM inclusions*. Except as otherwise provided in this paragraph (b)(2)(ii), the filing requirements under paragraph (b) of this section do not apply with respect to an interest in a PFIC owned by an indirect shareholder described in paragraph (b)(2)(i)(C) or (D)

of this section if another shareholder through which the indirect shareholder owns such interest in the PFIC timely files Form 8621 (or successor form) with respect to the PFIC under paragraph (b)(1) or (2) of this section. However, the exception in this paragraph (b)(2)(ii) does not apply with respect to a PFIC owned by an indirect shareholder described in paragraph (b)(2)(i)(C) of this section that owns the PFIC through a domestic partnership or S corporation if the domestic partnership or S corporation does not make a qualified electing fund election with respect to the PFIC (see §1.1293–1(c)(2)(ii), addressing QEF stock transferred to a pass through entity that does not make a section 1295 election).

(3) *Special rules for estates and trusts*—(i) *Domestic liquidating trusts and fixed investment trusts.* A United States person that is treated under sections 671 through 678 as the owner of any portion of a trust described in section 7701(a)(30)(E) that owns, directly or indirectly, any interest in a PFIC is not required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to the PFIC if the trust is either a domestic liquidating trust under §301.7701–4(d) of this chapter created pursuant to a court order issued in a bankruptcy under Chapter 7 (11 U.S.C. 701 *et seq.*) of the Bankruptcy Code or a confirmed plan under Chapter 11 (11 U.S.C. 1101 *et seq.*) of the Bankruptcy Code, or a widely held fixed investment trust under §1.671–5. Such a trust itself is treated as a shareholder for purposes of section 1298(f) and these regulations, and thus, except as otherwise provided in this section, the trust is required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to the PFIC as provided in paragraphs (b)(1) and (2) of this section.

(ii) *Beneficiaries of foreign estates and trusts.* A United States person that is considered to own an interest in a PFIC because it is a beneficiary of an estate described in section 7701(a)(31)(A) or a trust described in section 7701(a)(31)(B) that owns, directly or indirectly, stock of a PFIC, and that has not made an election under section 1295 or 1296 with respect to the PFIC, is not required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to the stock of the PFIC that it is considered to own through the estate or trust if, during the beneficiary's taxable year, the beneficiary is not treated as receiving an excess distribution (within the meaning of section 1291(b)) or as recognizing gain that is treated as an excess distribution (under section 1291(a)(2)) with respect to the stock.

(c) *Exceptions*—(1) *Exception if shareholder is a tax-exempt entity.* A shareholder that is an organization exempt under section 501(a) to the extent that it is described in section 501(c), 501(d), or 401(a), a state college or university described in section 511(a)(2)(B), a plan described in section 403(b) or 457(b), an individual retirement plan or annuity as defined in section 7701(a)(37), or a qualified tuition program described in section 529, a qualified ABLE program described in 529A, or a Coverdell education savings account described in section 530 is not required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to a PFIC unless the income derived with respect to the PFIC stock would be taxable to the organization under subchapter F of Subtitle A of the Code.

(2) *Exception if aggregate value of shareholder's PFIC stock is $25,000 or less, or value of shareholder's indirect PFIC stock is $5,000 or less*—(i) *General rule.* A shareholder is not required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to a section 1291 fund (as defined in §1.1291–1(b)(2)(v)) for a shareholder's taxable year if—

(A) On the last day of the shareholder's taxable year:

(*1*) The value of all PFIC stock owned directly or indirectly under section 1298(a) and §1.1291–1(b)(8) by the shareholder is $25,000 or less; or

(*2*) The section 1291 fund stock is indirectly owned by the shareholder under section 1298(a)(2)(B) and §1.1291–1(b)(8)(ii)(B), and the value of the section 1291 fund stock indirectly owned by the shareholder is $5,000 or less;

(B) The shareholder is not treated as receiving an excess distribution (within the meaning of section 1291(b)) with respect to the section 1291 fund during

the taxable year or as recognizing gain treated as an excess distribution under section 1291(a)(2) as the result of a disposition of the section 1291 fund during the taxable year; and

(C) An election under section 1295 has not been made to treat the section 1291 fund as a qualified electing fund with respect to the shareholder.

(ii) *Determination of the $25,000 threshold in the case of indirect ownership.* For purposes of determining the value of stock held by a shareholder for purposes of paragraph (c)(2)(i)(A)(*1*) of this section, the shareholder must take into account the value of all PFIC stock owned directly or indirectly under section 1298(a) and §1.1291–1(b)(8), except for PFIC stock that is—

(A) Owned through another United States person that itself is a shareholder of the PFIC (including a domestic partnership or S corporation treated as a shareholder of a PFIC for purposes of information reporting requirements applicable to a shareholder);

(B) Owned through a PFIC under section 1298(a)(2)(B) and §1.1291–1(b)(8)(ii)(B); or

(C) Marked to market for the shareholder's taxable year under any provision of chapter 1 of the Internal Revenue Code other than section 1296, provided the rules of §1.1296–1(i)(2) and (3) do not apply to the shareholder with respect to the PFIC stock pursuant to §1.1291–1(c)(4)(ii) for the shareholder's taxable year.

(iii) *Application of the $25,000 exception to shareholders who file a joint return.* In the case of a joint return, the exception described in paragraph (c)(2)(i)(A)(*1*) of this section shall apply if the value of all PFIC stock owned directly or indirectly (as determined under section 1298(a), §1.1291–1(b)(8), and paragraph (c)(2)(ii) of this section) by both spouses is $50,000 or less, and all of the other applicable requirements of paragraph (c)(2) of this section are met.

(iv) *Reliance on periodic account statements.* A shareholder may rely upon periodic account statements provided at least annually to determine the value of a PFIC unless the shareholder has actual knowledge or reason to know based on readily accessible information that the statements do not reflect a reasonable estimate of the PFIC's value.

(3) *Exception for PFIC stock marked to market under a provision other than section 1296.* A shareholder is not required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to a PFIC for any taxable year in which the PFIC is marked to market under any provision of chapter 1 of the Internal Revenue Code other than section 1296, provided the rules of §1.1296–1(i)(2) and (3) do not apply to the shareholder with respect to the PFIC pursuant to §1.1291–1(c)(4)(ii) for the taxable year.

(4) *Exception for PFIC stock held through certain foreign pension funds.* A shareholder who is a member or beneficiary of, or participant in, a plan, trust, scheme, or other arrangement that is treated as a foreign pension fund (or equivalent) under an income tax treaty to which the United States is a party and that owns, directly or indirectly, an interest in a PFIC is not required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to the PFIC interest if, pursuant to the applicable income tax treaty, the income earned by the foreign pension fund may be taxed as the income of the shareholder only when and to the extent the income is paid to, or for the benefit of, the shareholder.

(5) *Exception for certain shareholders who are dual resident taxpayers*—(i) *General rule.* Subject to the provisions of paragraphs (c)(5)(ii) and (iii) of this section, a shareholder is not required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to a PFIC for a taxable year, or the portion of a taxable year, in which the shareholder is a dual resident taxpayer (within the meaning of §301.7701(b)–7(a)(1) of this chapter) who is treated as a nonresident alien of the United States for purposes of computing his or her United States income tax liability pursuant to §301.7701(b)–7 of this chapter.

(ii) *Dual resident taxpayer filing as a nonresident alien at end of taxable year.* If a shareholder to whom this paragraph (c)(5) applies computes his or her U.S. income tax liability as a nonresident alien on the last day of the

taxable year and complies with the filing requirements of § 301.7701(b)–7(b) and (c) of this chapter and, in particular, such individual timely files with the Internal Revenue Service Form 1040NR, ''U.S. Nonresident Alien Income Tax Return,'' or Form 1040NR–EZ, ''U.S. Income Tax Return for Certain Nonresident Aliens With No Dependents,'' as applicable, and attaches thereto a properly completed Form 8833, ''Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b),'' and the schedule required by § 1.6012–1(b)(2)(ii)(*b*) (if applicable), such shareholder will not be required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to the taxable year, or the portion of the taxable year, covered by Form 1040NR (or Form 1040NR–EZ).

(iii) *Dual resident taxpayer filing as resident alien at end of taxable year.* If a shareholder to whom this paragraph (c)(5) applies computes his or her U.S. income tax liability as a resident alien on the last day of the taxable year and complies with the filing requirements of § 1.6012–1(b)(2)(ii)(*a*) and, in particular such shareholder timely files with the Internal Revenue Service Form 1040, ''U.S. Individual Income Tax Return,'' or Form 1040EZ, ''Income Tax Return for Single and Joint Filers With No Dependents,'' as applicable, and attaches a properly completed Form 8833 to the schedule required by § 1.6012–1(b)(2)(ii)(*a*), such shareholder will not be required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to the portion of the taxable year reflected on the schedule to such Form 1040 or Form 1040EZ required by § 1.6012–1(b)(2)(ii)(*a*).

(6) *Exception for certain domestic partnerships.* A shareholder that is a domestic partnership is not required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to a PFIC directly or indirectly held by the domestic partnership for a taxable year if each person that directly or indirectly owns an interest in the domestic partnership for its taxable year in which or with which the taxable year of the partnership ends is either—

(i) Not a shareholder of the PFIC as defined by § 1.1291–1(b)(7);

(ii) A tax-exempt entity or account not required to file Form 8621 with respect to the stock of the PFIC under paragraph (c)(1) of this section;

(iii) A dual resident taxpayer not required to file Form 8621 with respect to the stock of the PFIC under paragraph (c)(5) of this section; or

(iv) A domestic partnership not required to file Form 8621 with respect to the stock of the PFIC under this paragraph (c)(6).

(7) *Exception for certain short-term ownership of PFIC stock.* A shareholder is not required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to a section 1291 fund (as defined in § 1.1291–1(b)(2)(v)) for a taxable year when the shareholder—

(i) Acquires the section 1291 fund in the taxable year or the immediately preceding taxable year;

(ii) Is a shareholder of the section 1291 fund for a total of 30 days or less during the period beginning 29 days before the first day of the shareholder's taxable year and ending 29 days after the close of the shareholder's taxable year; and

(iii) Is not treated as receiving an excess distribution (within the meaning of section 1291(b)) with respect to the section 1291 fund, including any gain recognized that is treated as an excess distribution under section 1291(a)(2) as a result of the disposition of the section 1291 fund.

(8) *Exception for certain bona fide residents of certain U.S. territories.* A shareholder is not required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to a PFIC for a taxable year when the shareholder—

(i) Is a bona fide resident (as defined by section 937(a)) of Guam, the Northern Mariana Islands, or the United States Virgin Islands; and

(ii) Is not required to file an income tax return with the Internal Revenue Service with respect to such taxable year.

(9) *Exception for taxable years ending before December 31, 2013.* A United States person is not required under section 1298(f) and these regulations to file

an annual report with respect to a PFIC for a taxable year of the United States person ending before December 31, 2013.

(d) *Time and manner for filing.* A United States person required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to a PFIC must attach the form to its Federal income tax return (or information return, if applicable) for the taxable year to which the filing obligation relates on or before the due date (including extensions) for the filing of the return, or must separately file the form in accordance with the instructions for the form when the United States person is not required to file a Federal income tax return (or information return, if applicable) for the taxable year. In the case of any failure to report information that is required to be reported pursuant to section 1298(f) and these regulations, the time for assessment of tax will be extended pursuant to section 6501(c)(8).

(e) *Separate annual report for each PFIC*—(1) *General rule.* If a United States person is required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to more than one PFIC, the United States person must file a separate Form 8621 (or successor form) for each PFIC.

(2) *Special rule for shareholders who file a joint return.* United States persons that file a joint return may file a single Form 8621 (or successor form) with respect to a PFIC in which they jointly or individually own an interest.

(f) *Coordination rule.* A United States person that is a shareholder of a PFIC may file a single Form 8621 (or successor form) with respect to the PFIC that contains all of the information required to be reported pursuant to section 1298(f) and these regulations and any other information reporting requirements or election rules under other provisions of the Code.

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

Example 1. General requirement to file. (i) *Facts.* In 2013, J, a United States citizen, directly owns an interest in Partnership X, a domestic partnership, which, in turn, owns an interest in A Corp, which is a PFIC. In addition, J directly owns an interest in Partnership Y, a foreign partnership, which, in turn, owns an interest in A Corp. Neither J nor Partnership X has made a qualified electing fund election under section 1295 or a mark to market election under section 1296 with respect to A Corp. As of the last day of 2013, the value of Partnership X's interest in A Corp is $200,000, and the value of J's proportionate share of Partnership Y's interest in A Corp is $100,000. During 2013, J is not treated as receiving an excess distribution or recognizing gain treated as an excess distribution with respect to A Corp. Partnership X timely files a Form 8621 under section 1298(f) and paragraph (b)(1) of this section with respect to A Corp for 2013.

(ii) *Results.* J is the first United States person in the chain of ownership with respect to J's interest in A Corp held through Partnership Y. Under paragraph (b)(1) of this section, J must file a Form 8621 under section 1298(f) with respect to J's interest in A Corp held through Partnership Y because J is an indirect shareholder of A Corp under § 1.1291–1(b)(8) that holds PFIC stock through a foreign entity (Partnership Y), and there are no other United States persons in the chain of ownership. The fact that Partnership X filed a Form 8621 with respect to A Corp does not relieve J of the obligation under paragraph (b)(1) of this section to file a Form 8621 with respect to J's interest in A Corp held through Partnership Y. J has no filing obligation under section 1298(f) and paragraph (b)(2) of this section with respect to J's proportionate share of Partnership X's interest in A Corp.

Example 2. Application of the $25,000 exception. (i) *Facts.* In 2013, J, a United States citizen, directly owns stock of A Corp, B Corp, and C Corp, all of which were PFICs during 2013. As of the last day of 2013, the value of J's interests was $5,000 in A Corp, $10,000 in B Corp, and $4,000 in C Corp. J timely filed an election under section 1295 to treat A Corp as a qualified electing fund for the first year in which A Corp qualified as a PFIC, and a mark-to-market election under section 1296 with respect to the stock of B Corp. J did not make a qualified electing fund election under section 1295 or a mark to market election under section 1296 with respect to C Corp. J did not receive an excess distribution or recognize gain treated as an excess distribution in respect of C Corp during 2013.

(ii) *Results.* Under paragraph (b)(1) of this section, J must file separate Forms 8621 with respect to A Corp and B Corp for 2013. However, J is not required to file a Form 8621 with respect to C Corp because J owns, in the aggregate, PFIC stock with a value of less than $25,000 on the last day of J's taxable year, C Corp is not subject to a qualified electing fund election or mark to market election with respect to J, and J did not receive an excess distribution in respect of C Corp or recognize gain treated as an excess

distribution in respect of C Corp during 2013. Therefore, J qualifies for the $25,000 exception in paragraph (c)(2) of this section with respect to C Corp.

Example 3. Application of the $25,000 exception to indirect shareholder. (i) *Facts.* E, a United States citizen, directly owns an interest in Partnership X, a domestic partnership. Partnership X, in turn, directly owns an interest in A Corp and B Corp, both of which are PFICs. Partnership X timely filed an election under section 1295 to treat B Corp as a qualified electing fund for the first year in which B Corp qualified as a PFIC. In addition, E directly owns an interest in C Corp, which is a PFIC. C Corp, in turn, owns an interest in D Corp, which is a PFIC. E has not made a qualified electing fund election under section 1295 or a mark to market election under section 1296 with respect to A Corp, C Corp, or D Corp. As of the last day of 2013, the value of Partnership X's interest in A Corp is $30,000, the value of Partnership X's interest in B Corp is $30,000, the value of E's indirect interest in A Corp is $10,000, the value of E's indirect interest in B Corp is $10,000, the value of E's interest in C Corp is $20,000, and the value of C Corp's interest in D Corp is $10,000. During 2013, E did not receive an excess distribution, or recognize gain treated as an excess distribution, with respect to A Corp, C Corp, or D Corp. Partnership X timely files Forms 8621 under section 1298(f) and paragraph (b)(1) of this section with respect to A Corp and B Corp for 2013.

(ii) *Results.* Under paragraph (b) of this section, E does not have to file a Form 8621 under section 1298(f) and these regulations with respect to A Corp because E is not the United States person that is at the lowest tier in the chain of ownership with respect to A Corp and E did not receive an excess distribution or recognize gain treated as an excess distribution with respect to A Corp. Furthermore, under paragraph (b)(2)(ii) of this section, E does not have to file a Form 8621 under section 1298(f) and these regulations with respect to B Corp because Partnership X timely filed a Form 8621 with respect to B Corp. In addition, under paragraph (c)(2)(ii)(A) of this section, E does not take into account the value of A Corp and B Corp, which E owns through Partnership X, in determining whether E qualifies for the $25,000 exception. Further, under paragraph (c)(2)(ii)(B) of this section, E does not take into account the value of D Corp in determining whether E qualifies for the $25,000 exception. Therefore, even though E is the United States person that is at the lowest tier in the chain of ownership with respect to C Corp and D Corp, E does not have to file a Form 8621 with respect to C Corp or D Corp because E qualifies for the $25,000 exception set forth in paragraph (c)(2)(i)(A)(*1*) of this section.

Example 4. Indirect shareholder's requirement to file. (i) *Facts.* The facts are the same as in *Example 3* of this paragraph (g), except that the value of E's interest in C Corp is $30,000 and the value of E's proportionate share of C Corp's interest in D Corp is $3,000.

(ii) *Results.* The results are the same as in *Example 3* of this paragraph (g) with respect to E having no requirement to file a Form 8621 under section 1298(f) and these regulations with respect to A Corp and B Corp. However, under the facts in this *Example 4,* E does not qualify for the $25,000 exception under paragraph (c)(2)(i)(A)(*1*) of this section with respect to C Corp because the value of E's interest in C Corp is $30,000. Accordingly, E must file a Form 8621 under section 1298(f) and these regulations with respect to C Corp. However, E does qualify for the $5,000 exception under paragraph (c)(2)(i)(A)(*2*) of this section with respect to D Corp, and thus does not have to file a Form 8621 with respect to D Corp.

Example 5. Application of the domestic partnership exception. (i) *Facts.* Tax Exempt Entity A and Tax Exempt Entity B are both organizations exempt under section 501(a) because they are described in section 501(c). Tax Exempt Entity A and Tax Exempt Entity B own all the interests in Partnership X, a domestic partnership, which, in turn, owns, an interest in Partnership Y, also a domestic partnership. The remaining interests in Partnership Y are owned by F Corp, a foreign corporation owned solely by individuals that are not residents or citizens of the United States. Partnership Y owns an interest in A Corp, which is a PFIC. Any income derived with respect to A Corp would not be taxable to Tax Exempt Entity A or Tax Exempt Entity B under subchapter F of Subtitle A of the Code. Tax Exempt Entity A, Tax Exempt Entity B, Partnership X, and Partnership Y all are calendar year taxpayers.

(ii) *Results.* Under paragraph (c)(1) of this section, Tax Exempt Entity A and Tax Exempt Entity B do not have to file Form 8621 under section 1298(f) and these regulations with respect to A Corp because neither entity would be subject to tax under subchapter F of Subtitle A of the Code with respect to income derived from A Corp. In addition, under paragraph (c)(6) of this section, neither Partnership X nor Partnership Y is required to file Form 8621 under section 1298(f) and these regulations with respect to A Corp because all of the direct and indirect interests in Partnership X and Partnership Y are owned by persons described in paragraph (c)(1) of this section or persons that are not a shareholder of A Corp as defined by § 1.1291–1(b)(7).

(h) *Applicability dates.* (1) Except as provided in paragraph (h)(2) of this section, this section applies to taxable

years of shareholders ending on or after December 31, 2013.

(2) Paragraph (c)(9) of this section applies to taxable years of shareholders ending before December 31, 2013.

[T.D. 9806, 81 FR 95466, Dec. 28, 2016]

§ 1.1298–2 Rules for certain corporations changing businesses.

(a) *Overview*. This section provides rules under section 1298(b)(3) and 1298(g) that apply to certain foreign corporations that dispose of one or more active trades or businesses for purposes of determining whether a foreign corporation is treated as a passive foreign investment company (PFIC). Paragraph (b) of this section provides a rule that applies to certain foreign corporations that dispose of one or more active trades or businesses. Paragraph (c) of this section provides special rules. Paragraph (d) of this section provides a rule for the treatment of the disposition of the stock of a look-through subsidiary (as defined in § 1.1297–2(g)(3)) or partnership interests in a look-through partnership (as defined in § 1.1297–2(g)(4)). Paragraph (e) of this section provides guidance on when a tested foreign corporation can apply the change of business exception. Paragraph (f) provides examples illustrating the application of the rules in this section. Paragraph (g) provides the applicability date for this section.

(b) *Change of business exception*. A corporation is not treated as a PFIC for a taxable year if—

(1) Neither the corporation (nor any predecessor) was a PFIC for any prior taxable year;

(2) Either—

(i) Substantially all of the passive income of the corporation for the taxable year is attributable to proceeds from the disposition of one or more active trades or businesses; or

(ii) Following the disposition of one or more active trades or businesses, substantially all of the passive assets of the corporation on each of the measuring dates that occur during the taxable year and after the disposition are attributable to proceeds from the disposition; and

(3) The corporation reasonably does not expect to be and is not a PFIC for either of the first two taxable years following the taxable year.

(c) *Special rules*. The rules in this paragraph (c) apply for purposes of section 1298(b)(3) and this section.

(1) Income is attributable to proceeds from the disposition of one or more active trades or businesses to the extent the income is derived from the investment of the proceeds from the disposition of assets used in the active trades or businesses.

(2) Assets are attributable to proceeds from the disposition of one or more active trades or businesses only to the extent the assets are the proceeds of the disposition of assets used in the active trades or businesses, or are derived from the investment of the proceeds.

(3) The determination of the existence of an active trade or business and whether assets are used in an active trade or business is made under § 1.367(a)–2(d)(2), (3), and (5), except that officers and employees do not include the officers and employees of related entities as provided in § 1.367(a)–2(d)(3). However, if activities performed by the officers and employees of a look-through subsidiary of a corporation or of a look-through partnership (including a look-through subsidiary or a look-through partnership with respect to which paragraph (d) of this section applies) would be taken into account by the corporation pursuant to § 1.1297–2(e) if it applied, such activities are taken into account for purposes of the determination of the existence of an active trade or business and the determination of whether assets are used in an active trade or business.

(4) In the case of a corporation that satisfies the condition in paragraph (b)(2)(ii) of this section, the condition in paragraph (b)(3) of this section is deemed to be satisfied if the corporation completely liquidates by the end of the taxable year following the year with respect to which the tested foreign corporation applies the exception in paragraph (b) of this section.

(d) *Disposition of stock of a look-through subsidiary or partnership interests in a look-through partnership*. For purposes of paragraph (b) of this section, the proceeds from a tested foreign corporation's disposition of the stock

of a look-through subsidiary or of partnership interests in a look-through partnership are treated as proceeds from the disposition of a proportionate share of the assets held by the look-through subsidiary or look-through partnership on the date of the disposition, based on the method (value or adjusted bases) used to measure the assets of the tested foreign corporation for purposes of section 1297(a)(2). The proceeds attributable to assets used by the look-through subsidiary or look-through partnership in an active trade or business are treated as proceeds attributable to the disposition of an active trade or business.

(e) *Application of change of business exception.* A tested foreign corporation can apply the exception in paragraph (b) of this section with respect to a taxable year of a disposition of an active trade or business or an immediately succeeding taxable year, but cannot apply the exception with respect to more than one taxable year for a disposition.

(f) *Examples.* The following examples illustrate the rules of this section. For purposes of these examples: USP is a domestic corporation; TFC and FS are foreign corporations that are not controlled foreign corporations (within the meaning of section 957(a)); each corporation has outstanding a single class of stock; USP has owned its interest in TFC since the formation of TFC; each of USP, TFC, and FS have a calendar taxable year; and for purposes of section 1297(a)(2), TFC measures the amount of its assets based on value.

(1) *Example 1*—(i) *Facts.* (A) USP owns 15% of the outstanding stock of TFC. TFC owns 30% of the outstanding stock of FS. FS operates an active trade or business and 100% of its assets are used in the active trade or business. The value of FS's non-passive assets (as defined in §1.1297–1(f)(3)) is $900x; the value of FS's passive assets (which include cash and cash equivalents) is $100x. TFC has not been treated as a PFIC for any taxable year before Year 1 and has no predecessor. In addition to holding the FS stock, TFC directly conducts its own active trade or business. The value of TFC's non-passive assets (other than FS stock) is $50x; the value of TFC's passive assets (other than FS stock and assets received during Year 1) is $30x. TFC earns $1x of non-passive income (as defined in §1.1297–1(f)(4)) from its directly conducted active trade or business.

(B) On January 1, Year 1, TFC sells all of its FS stock for $300x. The residual gain computed under §1.1297–2(f)(2) on the sale of the FS stock is $10x. Under §1.1297–2(f)(3), $9x of residual gain is characterized as non-passive income and $1x of residual gain is characterized as passive income. TFC earned $5x of passive income from the investment of the proceeds from the disposition of the FS stock during each quarter of Year 1, and TFC maintained those earnings ($20x in total) as well as the disposition proceeds in cash for the remainder of the year. TFC reinvests the proceeds of the FS stock sale in an active trade or business during Year 2, and, thus, TFC is not a PFIC in Year 2 and Year 3. Less than 75% of TFC's gross income in Year 1 is passive income (($20x + $1x)/($10x + $20x + $1x) = 68%). However, subject to the application of section 1298(b)(3) and this section, TFC would be a PFIC in Year 1 under section 1297(a)(2) because the proceeds from the sale of the FS stock ($300x) together with TFC's other passive assets exceed 50% of TFC's total assets on each quarterly measuring date. For example, on the first quarterly measuring date TFC's ratio of passive assets to total assets is (($300x + $30x + $5x)/($300x + $30x + $5x + $50x)) and on the fourth quarterly measuring date TFC's ratio of passive assets to total assets is (($300x + $30x + $20x)/($300x + $30x + $20x + $50x)), each of which exceeds 87%. Therefore, TFC chooses to apply the change of business exception in paragraph (b) of this section to Year 1.

(ii) *Results.* (A) Under paragraph (d) of this section, for purposes of applying section 1298(b)(3)(B)(i) in Year 1, TFC's proceeds from the disposition of the stock of FS that are attributable to assets used by FS in an active trade or business are considered as from the disposition of an active trade or business. Because 100% of FS's assets are used in its active trade or business, all of TFC's proceeds are considered as from the disposition of an active trade or business. Therefore, under paragraph

(c)(1) of this section, the passive income considered attributable to proceeds from a disposition of one or more active trades or businesses is $20x (from investment of disposition proceeds). Because TFC reasonably does not expect to be a PFIC in Year 2 and Year 3, and TFC is not, in fact, a PFIC for those years, TFC will not be treated as a PFIC in Year 1 by reason of section 1298(b)(3) and paragraph (b) of this section, based on the satisfaction of the condition in paragraph (b)(2)(i) of this section, because the 95% ($20x/($20x + $1x)) of TFC's passive income for Year 1 that is attributable to proceeds of the disposition of FS's active trade or business constitutes substantially all of its passive income.

(B) TFC would also not be treated as a PFIC in Year 1 by reason of section 1298(b)(3) and paragraph (b) of this section, based on the satisfaction of the condition in paragraph (b)(2)(ii) of this section, because the over 91% of TFC's passive assets on the quarterly measuring dates during Year 1 following the disposition of the stock of FS that is attributable to proceeds of the disposition of FS's active trade or business constitutes substantially all of its passive assets. For example, on the first quarterly measuring date TFC's ratio of passive assets attributable to the proceeds of the disposition of FS's active trade or business to its total passive assets is 91% ($305x/($305x + $30x)), and the same ratio for the fourth quarterly measuring date is 91.4% ($320x/($320x + $30x)).

(C) Under paragraph (e) of this section, TFC cannot claim the section 1298(b)(3) exception in relation to the income attributable to the proceeds of the FS stock sale in Year 2 because TFC already claimed the exception for Year 1.

(2) *Example 2*—(i) *Facts*. The facts are the same as in paragraph (f)(1)(i) of this section (the facts in *Example 1*), except that during the first quarter of Year 1, TFC earned only $4x of passive income ($1x per quarter) from the investment of the proceeds from the disposition of the FS stock and earned $12x of passive income ($3x per quarter) from its other passive assets and maintained such earnings in cash for the remainder of the year.

(ii) *Results*. The results are the same as in paragraph (f)(1)(ii) of this section (the results in *Example 1*), except that under paragraph (c)(1) of this section, the passive income considered attributable to proceeds from a disposition of one or more active trades or businesses is $4x (from investment of disposition proceeds). Because 24% ($4x/($4x + $12x + $1x)) of TFC's passive income for Year 1 is attributable to proceeds of the disposition of FS's active trade or business, and 24% does not constitute substantially all of TFC's passive income for Year 1, TFC does not qualify for the exception from treatment as a PFIC in section 1298(b)(3) and paragraph (b)(2)(i) of this section for Year 1. However, under paragraphs (b)(2)(ii) and (d) of this section, more than $300x ($300x disposition proceeds + amounts earned from investment of disposition proceeds) of TFC's passive assets held on each quarterly measuring date after the disposition is considered attributable to the disposition of an active trade or business. Because TFC reasonably does not expect to be a PFIC in Year 2 and Year 3, and TFC is not, in fact, a PFIC for those years, TFC will not be treated as a PFIC in Year 1 by reason of paragraph (b) of this section, based on the satisfaction of the condition in paragraph (b)(2)(ii) of this section, assuming that the average 89% of TFC's passive assets on the quarterly measuring dates during Year 1 following the disposition of the stock of FS that is attributable to proceeds of the disposition of FS's active trade or business constitutes substantially all of its passive assets.

(g) *Applicability date*. The rules of this section apply to taxable years of shareholders beginning on or after January 14, 2021. A shareholder may choose to apply such rules for any open taxable year beginning before January 14, 2021, provided that, with respect to the tested foreign corporation, the shareholder consistently applies the provisions of this section and § 1.1291–1(b)(8)(iv) and (b)(8)(v)(A), (B), (C), and (D) and §§ 1.1297–1 (except that consistent treatment is not required with respect to § 1.1297–1(c)(1)(i)(A)), 1.1297–2, and

1.1298–4 for such year and all subsequent years.

[T.D. 9936, 86 FR 4576, Jan. 15, 2021, as amended at 86 FR 13648, Mar. 10, 2021]

§ 1.1298–3 Deemed sale or deemed dividend election by a U.S. person that is a shareholder of a former PFIC.

(a) *In general.* A shareholder (as defined in § 1.1291–9(j)(3)) of a foreign corporation that is a former PFIC, (as defined in § 1.1291–9(j)(2)(iv)) with respect to such shareholder, shall be treated for tax purposes as holding stock in a PFIC and therefore continues to be subject to taxation under section 1291 unless the shareholder makes a purging election under section 1298(b)(1). A purging election under section 1298(b)(1) is made under rules similar to the rules of section 1291(d)(2). Section 1291(d)(2) allows a shareholder to purge the continuing PFIC taint by making either a deemed sale election or a deemed dividend election.

(b) *Application of deemed sale election rules*—(1) *Eligibility to make the deemed sale election.* A shareholder of a foreign corporation that is a former PFIC with respect to such shareholder may make a deemed sale election under section 1298(b)(1) by applying the rules of this paragraph (b).

(2) *Effect of deemed sale election.* A shareholder making the deemed sale election with respect to a former PFIC shall be treated as having sold all its stock in the former PFIC for its fair market value on the termination date, as defined in paragraph (d) of this section. A deemed sale is treated as a disposition subject to taxation under section 1291. Thus, gain from the deemed sale is taxed under section 1291 as an excess distribution received on the termination date. In the case of an election made by an indirect shareholder, the amount of gain to be recognized and taxed as an excess distribution is the amount of gain that the direct owner of the stock of the PFIC would have realized on an actual sale or disposition of the stock of the PFIC indirectly owned by the shareholder. Any loss realized on the deemed sale is not recognized. After the deemed sale election, the shareholder's stock with respect to which the election was made under this paragraph (b) shall not be treated as stock in a PFIC and the shareholder shall not be subject to taxation under section 1291 with respect to such stock unless the foreign corporation thereafter qualifies as a PFIC under section 1297(a).

(3) *Time for making the deemed sale election.* Except as provided in paragraph (e) of this section, the shareholder shall make the deemed sale election under this paragraph (b) and section 1298(b)(1) in the shareholder's original or amended return for the taxable year that includes the termination date (election year). If the deemed sale election is made in an amended return, the return must be filed by a date that is within three years of the due date, as extended under section 6081, of the original return for the election year.

(4) *Manner of making the deemed sale election.* A shareholder makes the deemed sale election under this paragraph (b) by filing Form 8621 (''Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund'') with the return of the shareholder for the election year, reporting the gain as an excess distribution pursuant to section 1291(a) as if such deemed sale occurred under section 1291(d)(2), and paying the tax and interest due on the excess distribution. A shareholder that makes the deemed sale election after the due date of the return (determined without regard to extensions) for the election year must pay additional interest, pursuant to section 6601, on the amount of underpayment of tax for that year. An electing shareholder that realizes a loss shall report the loss on Form 8621, but shall not recognize the loss.

(5) *Adjustments to basis.* A shareholder that makes the deemed sale election increases its adjusted basis of the PFIC stock owned directly by the amount of gain recognized on the deemed sale. If the shareholder makes the deemed sale election with respect to a PFIC of which it is an indirect shareholder, the shareholder's adjusted basis of the stock or other property owned directly by the shareholder, through which ownership of the PFIC is attributed to the shareholder, is increased by the amount of gain recognized by the shareholder. In addition, solely for purposes of determining the subsequent

treatment under the Code and regulations of a shareholder of the stock of the PFIC, the adjusted basis of the direct owner of the stock of the PFIC is increased by the amount of gain recognized on the deemed sale. A shareholder shall not adjust the basis of any stock with respect to which the shareholder realized a loss on the deemed sale, but which loss is not recognized under paragraph (b)(2) of this section.

(6) *Treatment of holding period.* If a shareholder of a foreign corporation has made a deemed sale election, then, for purposes of applying sections 1291 through 1298 to such shareholder after the deemed sale, the shareholder's holding period in the stock of the foreign corporation begins on the day following the termination, without regard to whether the shareholder recognized gain on the deemed sale. For other purposes of the Code and regulations, this holding period rule does not apply.

(c) *Application of deemed dividend election rules*—(1) *Eligibility to make the deemed dividend election.* A shareholder of a foreign corporation that is a former PFIC with respect to such shareholder may make the deemed dividend election under the rules of this paragraph (c) provided the foreign corporation was a controlled foreign corporation (as defined in section 957(a) (CFC)) during its last taxable year as a PFIC. A shareholder may make the deemed dividend election without regard to whether the shareholder is a United States shareholder within the meaning of section 951(b). A deemed dividend election may be made by a shareholder whose pro rata share of the post-1986 earnings and profits of the PFIC attributable to the PFIC stock held on the termination date is zero.

(2) *Effect of the deemed dividend election.* A shareholder making the deemed dividend election with respect to a former PFIC shall include in income as a dividend its pro rata share of the post-1986 earnings and profits of the PFIC attributable to all of the stock it held, directly or indirectly on the termination date, as defined in paragraph (d) of this section. The deemed dividend is taxed under section 1291 as an excess distribution received on the termination date. The excess distribution determined under this paragraph (c) is allocated under section 1291(a)(1)(A) only to each day of the shareholder's holding period of the stock during which the foreign corporation qualified as a PFIC. For purposes of the preceding sentence, the shareholder's holding period of the PFIC stock ends on the termination date. After the deemed dividend election, the shareholder's stock with respect to which the election was made under this paragraph (c) shall not be treated as stock in a PFIC and the shareholder shall not be subject to taxation under section 1291 with respect to such stock unless the foreign corporation thereafter qualifies as a PFIC under section 1297(a).

(3) *Post-1986 earnings and profits defined:* (i) *In general.* For purposes of this section, the term *post-1986 earnings and profits* means the post-1986 undistributed earnings, within the meaning of section 902(c)(1) (determined without regard to section 902(c)(3)), as of the close of the taxable year that includes the termination date. For purposes of this computation, only earnings and profits accumulated in taxable years during which the foreign corporation was a PFIC shall be taken into account, without regard to whether the earnings relate to a period during which the PFIC was a CFC.

(ii) *Pro rata share of post-1986 earnings and profits attributable to shareholder's stock:* (A) *In general.* A shareholder's pro rata share of the post-1986 earnings and profits of the PFIC attributable to the stock held by the shareholder on the termination date is the amount of post-1986 earnings and profits of the PFIC accumulated during any portion of the shareholder's holding period ending at the close of the termination date and attributable, under the principles of section 1248 and the regulations under that section, to the PFIC stock held on the termination date.

(B) *Reduction for previously taxed amounts.* A shareholder's pro rata share of the post-1986 earnings and profits of the PFIC does not include any amount that the shareholder demonstrates to the satisfaction of the Commissioner (in the manner provided in paragraph (c)(5)(ii) of this section) was, pursuant to another provision of the law, previously included in the income of the

shareholder, or of another U.S. person if the shareholder's holding period of the PFIC stock includes the period during which the stock was held by that other U.S. person.

(4) *Time for making the deemed dividend election.* Except as provided in paragraph (e) of this section, the shareholder shall make the deemed dividend election under this paragraph (c) and section 1298(b)(1) in the shareholder's original or amended return for the taxable year that includes the termination date (election year). If the deemed dividend election is made in an amended return, the return must be filed by a date that is within three years of the due date, as extended under section 6081, of the original return for the election year.

(5) *Manner of making the deemed dividend election:* (i) *In general.* A shareholder makes the deemed dividend election by filing Form 8621 and the attachment to Form 8621 described in paragraph (c)(5)(ii) of this section with the return of the shareholder for the election year, reporting the deemed dividend as an excess distribution pursuant to section 1291(a)(1), and paying the tax and interest due on the excess distribution. A shareholder that makes the deemed dividend election after the due date of the return (determined without regard to extensions) for the election year must pay additional interest, pursuant to section 6601, on the amount of underpayment of tax for that year.

(ii) *Attachment to Form 8621.* The shareholder must attach a schedule to Form 8621 that demonstrates the calculation of the shareholder's pro rata share of the post-1986 earnings and profits of the PFIC that is treated as distributed to the shareholder on the termination date pursuant to this paragraph (c). If the shareholder is claiming an exclusion from its pro rata share of the post-1986 earnings and profits for an amount previously included in its income or the income of another U.S. person, the shareholder must include the following information:

(A) The name, address, and taxpayer identification number of each U.S. person that previously included an amount in income, the amount previously included in income by each such U.S. person, the provision of law pursuant to which the amount was previously included in income, and the taxable year or years of inclusion of each amount.

(B) A description of the transaction pursuant to which the shareholder acquired, directly or indirectly, the stock of the PFIC from another U.S. person, and the provision of law pursuant to which the shareholder's holding period includes the period the other U.S. person held the CFC stock.

(6) *Adjustments to basis.* A shareholder that makes the deemed dividend election increases its adjusted basis of the stock of the PFIC owned directly by the shareholder by the amount of the deemed dividend. If the shareholder makes the deemed dividend election with respect to a PFIC of which it is an indirect shareholder, the shareholder's adjusted basis of the stock or other property owned directly by the shareholder, through which ownership of the PFIC is attributed to the shareholder, is increased by the amount of the deemed dividend. In addition, solely for purposes of determining the subsequent treatment under the Code and regulations of a shareholder of the stock of the PFIC, the adjusted basis of the direct owner of the stock of the PFIC is increased by the amount of the deemed dividend.

(7) *Treatment of holding period.* If the shareholder of a foreign corporation has made a deemed dividend election, then, for purposes of applying sections 1291 through 1298 to such shareholder after the deemed dividend, the shareholder's holding period of the stock of the foreign corporation begins on the day following the termination date. For other purposes of the Code and regulations, this holding period rule does not apply.

(8) *Coordination with section 959(e).* For purposes of section 959(e), the entire deemed dividend is treated as having been included in gross income under section 1248(a).

(d) *Termination date.* For purposes of this section, the termination date is the last day of the last taxable year of the foreign corporation during which it qualified as a PFIC under section 1297(a).

(e) *Late purging elections requiring special consent*—(1) *In general*. This section prescribes the exclusive rules under which a shareholder of a former PFIC may make a section 1298(b)(1) election after the time prescribed in paragraph (b)(3) or (c)(4) of this section for making a deemed sale or a deemed dividend election has elapsed (late purging election). Therefore, a shareholder may not seek such relief under any other provisions of the law, including § 301.9100–3 of this chapter. A shareholder may request the consent of the Commissioner to make a late purging election for the taxable year of the shareholder that includes the termination date provided the shareholder satisfies the requirements set forth in this paragraph (e). The Commissioner may, in his discretion, grant relief under this paragraph (e) only if—

(i) In a case where the shareholder is requesting consent under this paragraph (e) after December 31, 2005, the shareholder requests such consent before a representative of the Internal Revenue Service raises upon audit the PFIC status of the foreign corporation for any taxable year of the shareholder;

(ii) The shareholder has agreed in a closing agreement with the Commissioner, described in paragraph (e)(3) of this section, to eliminate any prejudice to the interests of the U.S. government, as determined under paragraph (e)(2) of this section, as a consequence of the shareholder's inability to file amended returns for its taxable year in which the termination date falls or an earlier closed taxable year in which the shareholder has taken a position that is inconsistent with the treatment of the foreign corporation as a PFIC; and

(iii) The shareholder satisfies the procedural requirements set forth in paragraph (e)(3) of this section.

(2) *Prejudice to the interests of the U.S. government*. The interests of the U.S. government are prejudiced if granting relief would result in the shareholder having a lower tax liability (other than by a *de minimis* amount), taking into account applicable interest charges, for the taxable year that includes the termination date (or a prior taxable year in which the taxpayer took a position on a return that was inconsistent with the treatment of the foreign corporation as a PFIC) than the shareholder would have had if the shareholder had properly made the section 1298(b)(1) election in the time prescribed in paragraph (b)(2) or (c)(3) of this section (or had not taken a position in a return for an earlier year that was inconsistent with the status of the foreign corporation as a PFIC). The time value of money is taken into account for purposes of this computation.

(3) *Procedural requirements*—(i) *In general*. The amount due with respect to a late purging election is determined in the same manner as if the purging election had been timely filed. However, the shareholder is also liable for interest on the amount due, pursuant to section 6601, determined for the period beginning on the due date (without extensions) for the taxpayer's income tax return for the year in which the termination date falls and ending on the date the late purging election is filed with the IRS.

(ii) *Filing instructions*. A late purging election is made by filing a completed Form 8621–A, ''Return by a Shareholder Making Certain Late Elections to End Treatment as a Passive Foreign Investment Company.''

(4) *Time and manner of making late election*—(i) *Time for making a late purging election*. A shareholder may make a late purging election in the manner provided in paragraph (e)(4)(ii) of this section at any time. The date the election is filed with the IRS will determine the amount of interest due under paragraph (e)(3) of this section.

(ii) *Manner of making a late purging election*. A shareholder makes a late purging election by completing Form 8621–A in the manner required by that form and this section and filing that form with the Internal Revenue Service, DP 8621–A, Ogden, UT 84201.

(5) *Multiple late elections*. For rules regarding the circumstances under which a shareholder of a foreign corporation may make multiple late purging elections under this paragraph (e) or § 1.1297–3(e), see § 1.1297–3(e)(5).

(f) *Effective/applicability date*. The rules of this section are applicable as of December 8, 2005.

[T.D. 9231, 70 FR 72915, Dec. 8, 2005, as amended by T.D. 9360, 72 FR 54824, Sept. 27, 2007]

§ 1.1298–4 Rules for certain foreign corporations owning stock in 25-percent-owned domestic corporations.

(a) *Overview.* This section provides rules under section 1298(b)(7) that apply to certain foreign corporations that own stock in 25-percent-owned domestic corporations (as defined in paragraph (b) of this section) for purposes of determining whether a foreign corporation is a passive foreign investment company (PFIC). Paragraph (b) of this section provides the general rule. Paragraph (c) of this section provides rules concerning ownership of 25-percent-owned domestic corporations or qualified stock (as defined in paragraph (b)(2) of this section) through partnerships. Paragraph (d) of this section provides rules for determining whether a foreign corporation is subject to the tax imposed by section 531 (the section 531 tax) and for waiving treaty benefits that would prevent the imposition of such tax. Paragraph (e) of this section provides an anti-abuse rule for the application of section 1298(b)(7). Paragraph (f) provides the applicability date for this section.

(b) *Treatment of certain foreign corporations owning stock in a 25-percent-owned domestic corporation*—(1) *General rule.* Except as otherwise provided in paragraph (e) of this section, when a tested foreign corporation (as defined in § 1.1297–1(f)) is subject to the section 531 tax (or waives any benefit under any treaty that would otherwise prevent the imposition of the tax), and owns (directly or indirectly under the rules in paragraph (c) of this section) at least 25 percent (by value) of the stock of a domestic corporation (a *25-percent-owned domestic corporation*), for purposes of determining whether the foreign corporation is a PFIC, any qualified stock held directly or indirectly under the rules in paragraph (c) of this section by the 25-percent-owned domestic corporation is treated as an asset that does not produce passive income (and is not held for the production of passive income), and any amount included in gross income with respect to the qualified stock is not treated as passive income.

(2) *Qualified stock and second-tier domestic corporation.* For purposes of this section, the term *qualified stock* means any stock in a C corporation that is a domestic corporation and that is not a regulated investment company or real estate investment trust and the term *second-tier corporation* means the corporation.

(c) *Indirect ownership of stock through a partnership.* For purposes of paragraph (b)(1) of this section, a tested foreign corporation that is a partner in a partnership is considered to own its proportionate share of any stock of a domestic corporation held by the partnership, and a domestic corporation that is a partner in a partnership is considered to own its proportionate share of any qualified stock held by the partnership. An upper-tier partnership's attributable share of the stock of a domestic corporation or of qualified stock held by a lower-tier partnership is treated as held by the upper-tier partnership for purposes of applying the rule in this paragraph (c).

(d) *Section 531 tax*—(1) *Subject to section 531 tax.* For purposes of paragraph (b) of this section, a tested foreign corporation is considered subject to the section 531 tax regardless of whether the tax is imposed on the corporation and of whether the requirements of § 1.532–1(c) are met.

(2) *Waiver of treaty benefits*—(i) *Tested foreign corporation that files, or is required to file, a Federal income tax return.* For purposes of paragraph (b) of this section, a tested foreign corporation that files, or is required to file, a Federal income tax return waives the benefit under a treaty that would otherwise prevent the imposition of the section 531 tax by attaching to its original or amended return for the taxable year for which section 1298(b)(7) and paragraph (b)(1) of this section are applied or any prior taxable year a statement that it irrevocably waives treaty protection against the imposition of the section 531 tax, effective for all prior, current, and future taxable years, provided the taxable year for which the return is filed and all subsequent taxable years are not closed by the period of limitations on assessments under section 6501.

(ii) *Tested foreign corporation that is not required to file a Federal income tax return.* For purposes of paragraph (b) of

this section, a tested foreign corporation that is not required to file a Federal income tax return waives the benefit under a treaty that would otherwise prevent the imposition of the section 531 tax by a date no later than nine months following the close of the taxable year for which section 1298(b)(7) and paragraph (b)(1) of this section are applied by—

(A) Adopting a resolution or similar governance document that confirms that it has irrevocably waived any treaty protection against the imposition of the section 531 tax, effective for all prior, current, and future taxable years, and maintaining a copy of the resolution (or other governance document) in its records; or

(B) In the case of a tested foreign corporation described in section 1297(e)(3), including in its public filings a statement that it irrevocably waives treaty protection against the imposition of the section 531 tax, effective for all prior, current, and future taxable years.

(e) *Anti-abuse rule*—(1) *General rule*. Paragraph (b) of this section does not apply with respect to qualified stock in a second-tier domestic corporation owned by a 25-percent-owned domestic corporation if a principal purpose for the formation of, acquisition of, or holding of stock of the 25-percent-owned domestic corporation or the second-tier domestic corporation, or for the capitalization or other funding of the second-tier domestic corporation, is to hold passive assets (as defined in § 1.1297–1(f)(5)) through the second-tier domestic corporation to avoid classification of the tested foreign corporation as a PFIC.

(2) [Reserved]

(3) [Reserved]

(f) *Applicability date*. The rules of this section apply to taxable years of shareholders beginning on or after January 14, 2021. A shareholder may choose to apply such rules for any open taxable year beginning before January 14, 2021, provided that, with respect to a tested foreign corporation, the shareholder consistently applies the provisions of this section and § 1.1291–1(b)(8)(iv) and (b)(8)(v)(A), (B), (C), and (D) and §§ 1.1297–1 (except that consistent treatment is not required with respect to § 1.1297–1(c)(1)(i)(A)), 1.1297–2, and 1.1298–2 for such year and all subsequent years.

[T.D. 9936, 86 FR 4578, Jan. 15, 2021, as amended at 86 FR 13648, Mar. 10, 2021]

INCOME AVERAGING

§ 1.1301–1 Averaging of farm and fishing income.

(a) *Overview*. An individual engaged in a farming or fishing business may make a farm income averaging election to compute current year (election year) income tax liability under section 1 by averaging, over the prior three-year period (base years), all or a portion of the individual's current year electible farm income as defined in paragraph (e) of this section. Electible farm income includes income from both farming and fishing businesses. An individual who makes a farm income averaging election—

(1) Designates all or a portion of the individual's electible farm income for the election year as elected farm income; and

(2) Determines the election year section 1 tax by calculating the sum of—

(i) The section 1 tax that would be imposed for the election year if taxable income for the year were reduced by elected farm income; plus

(ii) The amount by which the section 1 tax would be increased if taxable income for each base year were increased by one-third of elected farm income.

(b) *Individual engaged in a farming or fishing business*—(1) *In general*—(i) *Farming or fishing business*. ''Farming business'' has the same meaning as provided in section 263A(e)(4) and the regulations under that section. *Fishing business* means the conduct of commercial fishing as defined in section 3 of the Magnuson-Stevens Fishery Conservation and Management Act (16 U.S.C. 1802(4)). Accordingly, a fishing business is fishing in which the fish harvested are intended to or do enter commerce through sale, barter, or trade. *Fishing* means the catching, taking, or harvesting of fish; the attempted catching, taking, or harvesting of fish; any activities that reasonably can be expected to result in the catching, taking, or harvesting of

fish; or any operations at sea in support of or in preparation for the catching, taking, or harvesting of fish. Fishing does not include any scientific research activity conducted by a scientific research vessel. *Fish* means finfish, mollusks, crustaceans, and all other forms of marine animal and plant life, other than marine mammals and birds. *Catching, taking, or harvesting* includes activities that result in the killing of fish or the bringing of live fish on board a vessel.

(ii) *Exxon Valdez settlement payments.* For purposes of this section, a qualified taxpayer who receives qualified settlement income in any taxable year is treated as engaged in a fishing business, and the income is treated as income attributable to a fishing business, for that taxable year. A *qualified taxpayer* is an individual plaintiff in the civil action *In re Exxon Valdez,* No. 89–095–CV (HRH) (Consolidated) (D. Alaska). *Qualified taxpayer* also means any individual who is a beneficiary of the estate of such a plaintiff, was the spouse or immediate relative of that plaintiff, and acquired the right to receive the settlement income from that plaintiff. *Qualified settlement income* means any interest and punitive damage awards that are received in connection with the civil action *In re Exxon Valdez* (whether as lump-sum or periodic payments, whether pre- or post-judgment, and whether related to a settlement or to a judgment) and that are otherwise includible in income.

(iii) *Form of business.* An individual engaged in a farming or fishing business includes a sole proprietor of a farming or fishing business, a partner in a partnership engaged in a farming or fishing business, and a shareholder of an S corporation engaged in a farming or fishing business. Except as provided in paragraph (e)(1)(i) of this section, services performed as an employee are disregarded in determining whether an individual is engaged in a farming or fishing business for purposes of section 1301 of the Internal Revenue Code.

(iv) *Base years.* An individual is not required to have been engaged in a farming or fishing business in any of the base years in order to make a farm income averaging election.

(2) *Certain landlords.* A landlord is engaged in a farming business for purposes of section 1301 with respect to rental income that is based on a share of production from a tenant's farming business and, with respect to amounts received on or after January 1, 2003, is determined under a written agreement entered into before the tenant begins significant activities on the land. A landlord is not engaged in a farming business for purposes of section 1301 with respect to either fixed rent or, with respect to amounts received on or after January 1, 2003, rental income based on a share of a tenant's production determined under an unwritten agreement or a written agreement entered into after the tenant begins significant activities on the land. Whether the landlord materially participates in the tenant's farming business is irrelevant for purposes of section 1301.

(3) *Lessors of vessels used in fishing.* A lessor of a vessel is engaged in a fishing business for purposes of section 1301 with respect to payments that are received under the lease and are based on a share of the catch from the lessee's use of the vessel in a fishing business (or a share of the proceeds from the sale of the catch) if this manner of payment is determined under a written lease agreement entered into before the lessee begins any significant fishing activities resulting in the catch. A lessor of a vessel is not engaged in a fishing business for purposes of section 1301 with respect to fixed lease payments or with respect to lease payments based on a share of the lessee's catch (or a share of the proceeds from the sale of the catch) if the share is determined under either an unwritten agreement or a written agreement entered into after the lessee begins significant fishing activities resulting in the catch.

(c) *Making, changing, or revoking an election*—(1) *In general.* A farm income averaging election is made by filing Schedule J, ''Income Averaging for Farmers and Fishermen,'' with an individual's Federal income tax return for the election year (including a late or amended return if the period of limitation on filing a claim for credit or refund has not expired).

(2) *Changing or revoking an election.* An individual may change the amount of the elected farm income in a previous election or revoke a previous election if the period of limitations on filing a claim for credit or refund has not expired for the election year.

(d) *Guidelines for calculation of section 1 tax*—(1) *Actual taxable income not affected.* Under paragraph (a)(2) of this section, a determination of the section 1 tax for the election year involves a computation of the section 1 tax that would be imposed if taxable income for the election year were reduced by elected farm income and taxable income for each of the base years were increased by one-third of elected farm income. The reduction and increases required for purposes of this computation do not affect the actual taxable income for either the election year or the base years. Thus, for each of those years, the actual taxable income is taxable income determined without regard to any hypothetical reduction or increase required for purposes of the computation under paragraph (a)(2) of this section. The following illustrates this principle:

(i) Any reduction or increase in taxable income required for purposes of the computation under paragraph (a)(2) of this section is disregarded in determining the taxable year in which a net operating loss carryover or net capital loss carryover is applied.

(ii) The net section 1231 gain or loss and the character of any section 1231 items for the election year is determined without regard to any reduction in taxable income required for purposes of the computation under paragraph (a)(2) of this section.

(iii) The section 68 overall limitation on itemized deductions for the election year is determined without regard to any reduction in taxable income required for purposes of the computation under paragraph (a)(2) of this section. Similarly, the section 68 limitation for a base year is not recomputed to take into account any allocation of elected farm income to the base year for such purposes.

(iv) If a base year had a partially used capital loss, the remaining capital loss may not be applied to reduce the elected farm income allocated to the year for purposes of the computation under paragraph (a)(2) of this section.

(v) If a base year had a partially used credit, the remaining credit may not be applied to reduce the section 1 tax attributable to the elected farm income allocated to the year for purposes of the computation under paragraph (a)(2) of this section.

(2) *Computation in base years*—(i) *In general.* As provided in paragraph (a)(2)(ii) of this section, the election year section 1 tax includes the amounts by which the section 1 tax for each base year would be increased if taxable income for the year were increased by one-third of elected farm income. For this purpose, all allowable deductions (including the full amount of any net operating loss carryover) are taken into account in determining the taxable income for the base year even if the deductions exceed gross income and the result is negative. If the result is negative, however, any amount that may provide a benefit in another taxable year is added back in determining base year taxable income. Amounts that may provide a benefit in another year include—

(A) The net operating loss (as defined in section 172(c)) for the base year;

(B) The net operating loss for any other year to the extent carried forward from the base year under section 172(b)(2); and

(C) The capital loss deduction allowed for the base year under section 1211(b)(1) or (2) to the extent such deduction does not reduce the capital loss carryover from the base year because it exceeds adjusted taxable income (as defined in section 1212(b)(2)(B)).

(ii) *Example.* The rules of this paragraph (d)(2) are illustrated by the following example:

Example. In 2001, F and F's spouse on their joint return elect to average $24,000 of income attributable to a farming business. One-third of the elected farm income, $8,000, is added to the 1999 base year income. In 1999, F and F's spouse reported adjusted gross income of $7,300 and claimed a standard deduction of $7,200 and a deduction for personal exemptions of $8,250. Therefore, their 1999 base year taxable income is −$8,150 [$7,300 − ($7,200 + $8,250)]. After adding the elected farm income to the negative taxable income, their 1999 base year taxable income would be zero [$8,000 + (−$8,150) = −$150]. If F and F's spouse

elected to income average in 2002, and made the adjustments described in paragraph (d)(3) of this section to account for the 2001 election, their 1999 base year taxable income for the 2002 election would be −$150.

(3) *Effect on subsequent elections*—(i) *In general*. The reduction and increases in taxable income assumed in computing the election year section 1 tax (within the meaning of paragraph (a)(2) of this section) for an election year are treated as having actually occurred for purposes of computing the election year section 1 tax for any subsequent election year. Thus, if a base year for a farm income averaging election is also an election year for another farm income averaging election, the increase in the section 1 tax for that base year is determined after reducing taxable income by the elected farm income from the earlier election year. Similarly, if a base year for a farm income averaging election is also a base year for another farm income averaging election, the increase in the section 1 tax for that base year is determined after increasing taxable income by elected farm income allocated to the year from the earlier election year.

(ii) *Example*. The rules of this paragraph (d)(3) are illustrated by the following example:

Example. (i) T is a fisherman who uses the calendar taxable year. In each of the years 2007, 2008, and 2009, T's taxable income is $20,000, none of which is electible farm income. In 2010, T has taxable income of $30,000 (prior to any farm income averaging election), $10,000 of which is electible farm income. T makes a farm income averaging election with respect to $9,000 of the electible farm income for 2010. Under paragraph (a)(2)(ii) of this section, $3,000 of elected farm income is allocated to each of the base years 2007, 2008, and 2009. Under paragraph (a)(2) of this section, T's 2010 tax liability is the sum of the following amounts:

(A) The section 1 tax on $21,000, which is T's taxable income of $30,000, minus elected farm income of $9,000.

(B) For each of the base years 2007, 2008, and 2009, the amount by which the section 1 tax would be increased if one-third of elected farm income were allocated to each year. The amount for each year is the section 1 tax on $23,000 (T's taxable income of $20,000, plus $3,000, which is one-third of elected farm income for the 2010 election year), minus the section 1 tax on $20,000.

(ii) In 2011, T has taxable income of $50,000, $12,000 of which is electible farm income. T makes a farm income averaging election with respect to all $12,000 of the electible farm income for 2011. Under paragraph (a)(2)(ii) of this section, $4,000 of elected farm income is allocated to each of the base years 2008, 2009, and 2010. Under paragraph (a)(2) of this section, T's 2011 tax liability is the sum of the following amounts:

(A) The section 1 tax on $38,000, which is T's taxable income of $50,000, minus elected farm income of $12,000.

(B) For each of the base years 2008 and 2009, the amount by which section 1 tax would be increased if, after adjustments for previous farm income averaging elections pursuant to paragraph (d)(3)(i) of this section, one-third of 2011 elected farm income were allocated to each year. The amount for each year is the section 1 tax on $27,000 (T's taxable income of $20,000 increased by $3,000 for T's 2010 farm income averaging election and further increased by $4,000, which is one-third of elected farm income for the 2011 election year), minus the section 1 tax on $23,000 (T's taxable income of $20,000 increased by $3,000 for T's 2010 farm income averaging election).

(C) For base year 2010, the amount by which section 1 tax would be increased if, after adjustments for previous farm income averaging elections pursuant to paragraph (d)(3)(i) of this section, one-third of elected farm income were allocated to that year. This amount is the section 1 tax on $25,000 (T's 2010 taxable income of $30,000 reduced by $9,000 for T's 2010 farm income averaging election and increased by $4,000, which is one-third of elected farm income for the 2011 election year), minus the section 1 tax on $21,000 (T's taxable income of $30,000 reduced by $9,000 for T's 2010 farm income averaging election).

(4) *Deposits into Merchant Marine Capital Construction Fund*—(i) *Reductions to taxable income and electible farm income*. Under section 7518(c)(1)(A), certain deposits to a Merchant Marine Capital Construction Fund (CCF) reduce taxable income for purposes of the Internal Revenue Code (the CCF reduction). The amount of the CCF reduction is limited under section 7518(a)(1)(A) to the taxpayer's taxable income (determined without regard to the reduction) attributable to specified maritime operations including operations in fisheries of the United States. The CCF reduction is taken into account in determining the taxable income used in computations under this section. In addition, except to the extent the amount described in section 7518(a)(1)(A) is not attributable to the individual's fishing business, the CCF reduction is treated

in computing electible farm income as an item of deduction attributable to the individual's fishing business.

(ii) *Example*. The rules of this paragraph (d)(4) are illustrated by the following example:

Example. (i) T is a fisherman who uses the calendar taxable year. In each of the years 2007, 2008, and 2009, T's taxable income (before taking any CCF reduction into account) is $20,000. For taxable year 2008, all of T's income is described in section 7518(a)(1)(A) and is attributable to T's fishing business. T makes a $5,000 deposit into a CCF for taxable year 2008. In 2010, T has total taxable income of $30,000 (before taking any CCF reduction into account). T's electible farm income for 2010 (before taking the CCF reduction into account) is $10,000, all of which is described in section 7518(a)(1)(A) and is attributable to T's fishing business. For taxable year 2010, T makes a $4,000 deposit into a CCF.

(ii) The amount of the 2010 CCF deposit reduces taxable income. Accordingly, T's taxable income for 2010 is $26,000 ($30,000–$4,000). In addition, the entire amount of the CCF reduction is treated as an item of deduction attributable to T's fishing business. Accordingly, T's electible farm income for 2010 is $6,000 ($10,000–$4,000). Similarly, the amount of the 2008 CCF deposit reduces T's taxable income for 2008. Accordingly, T's taxable income for 2008 is $15,000 ($20,000–$5,000).

(iii) T makes an income averaging election with respect to all $6,000 of the electible farm income for 2010. Under paragraph (a)(2)(ii) of this section, $2,000 of elected farm income is allocated to each of the base years 2007, 2008, and 2009. Under paragraph (a)(2) of this section, T's 2010 tax liability is the sum of the following amounts:

(A) The section 1 tax on $20,000, which is T's taxable income of $26,000 ($30,000 reduced by the $4,000 CCF deposit), minus elected farm income of $6,000.

(B) For each of the base years 2007, 2008, and 2009, the amount by which section 1 tax would be increased if one-third of elected farm income were allocated to each year. The amount for base years 2007 and 2009 is the section 1 tax on $22,000, (T's taxable income of $20,000, plus $2,000, which is one-third of elected farm income for the election year), minus the section 1 tax on $20,000. The amount for base year 2008 is the section 1 tax on $17,000, which is T's taxable income of $15,000 ($20,000 reduced by the $5,000 CCF deposit), plus $2,000 (one-third of elected farm income for the election year), minus the section 1 tax on $15,000.

(e) *Electible farm income*—(1) *Identification of items attributable to a farming or fishing business*—(i) *In general*. Farm and fishing income includes items of income, deduction, gain, and loss attributable to an individual's farming or fishing business. Farm and fishing losses include, to the extent attributable to a farming or fishing business, any net operating loss carryover or carryback or net capital loss carryover to an election year. Income, gain, or loss from the sale of development rights, grazing rights, and other similar rights is not treated as attributable to a farming business. In general, farm and fishing income does not include compensation received as an employee. However, a shareholder of an S corporation engaged in a farming or fishing business may treat compensation received from the corporation as farm or fishing income if the compensation is paid by the corporation in the conduct of the farming or fishing business. If a crewmember on a vessel engaged in commercial fishing (within the meaning of section 3 of the Magnuson-Stevens Fishery Conservation and Management Act, 16 U.S.C. 1802(4)) is compensated by a share of the boat's catch of fish or a share of the proceeds from the sale of the catch, the crewmember is treated for purposes of section 1301 as engaged in a fishing business and the compensation is treated for such purposes as income from a fishing business.

(ii) *Gain or loss on sale or other disposition of property*—(A) *In general*. Gain or loss from the sale or other disposition of property that was regularly used in the individual's farming or fishing business for a substantial period of time is treated as attributable to a farming or fishing business. For this purpose, the term *property* does not include land, but does include structures affixed to land. Property that has always been used solely in the farming or fishing business by the individual is deemed to meet both the regularly used and substantial period tests. Whether property not used solely in the farming or fishing business was regularly used in the farming or fishing business for a substantial period of time depends on all of the facts and circumstances.

(B) *Cessation of a farming or fishing business*. If gain or loss described in paragraph (e)(1)(ii)(A) of this section is realized after cessation of a farming or

fishing business, the gain or loss is treated as attributable to a farming or fishing business only if the property is sold within a reasonable time after cessation of the farming or fishing business. A sale or other disposition within one year of cessation of the farming or fishing business is presumed to be within a reasonable time. Whether a sale or other disposition that occurs more than one year after cessation of the farming or fishing business is within a reasonable time depends on all of the facts and circumstances.

(2) *Determination of amount that may be elected farm income*—(i) *Electible farm income*. (A) The maximum amount of income that an individual may elect to average (electible farm income) is the sum of any farm and fishing income and gains, minus any farm and fishing deductions or losses (including loss carryovers and carrybacks) that are allowed as a deduction in computing the individual's taxable income.

(B) Individuals conducting both a farming business and a fishing business must calculate electible farm income by combining income, gains, deductions, and losses derived from the farming business and the fishing business.

(C) Except as otherwise provided in paragraph (d)(4) of this section, the amount of any CCF reduction is treated as a deduction from income attributable to a fishing business in calculating electible farm income.

(D) Electible farm income may not exceed taxable income, and electible farm income from net capital gain attributable to a farming or fishing business may not exceed total net capital gain. Subject to these limitations, an individual who has both ordinary income and net capital gain from a farming or fishing business may elect to average any combination of the ordinary income and net capital gain.

(ii) *Examples*. The rules of this paragraph (e)(2) are illustrated by the following examples:

Example 1. A has ordinary income from a farming business of $200,000 and deductible expenses from a farming business of $50,000. A's taxable income is $150,000 ($200,000–$50,000). Under paragraph (e)(2)(i) of this section, A's electible farm income is $150,000, all of which is ordinary income.

Example 2. B has capital gain of $20,000 that is not from a farming or fishing business, capital loss from a farming business of $30,000, and ordinary income from a farming business of $100,000. Under section 1211(b), B's allowable capital loss is limited to $23,000. B's taxable income is $97,000 (($20,000–$23,000) + $100,000). B has a capital loss carryover from a farming business of $7,000 ($30,000 total loss − $23,000 allowable loss). Under paragraph (e)(2)(i) of this section, B's electible farm income is $77,000 ($100,000 ordinary income from a farming business, minus $23,000 capital loss from a farming business), all of which is ordinary income.

Example 3. C has ordinary income from a fishing business of $200,000 and ordinary loss from a farming business of $60,000. C's taxable income is $140,000 ($200,000 − $60,000). Under paragraph (e)(2)(i)(B) of this section, C must deduct the farm loss from the fishing income in determining C's electible farm income. Therefore, C's electible farm income is $140,000 ($200,000–$60,000), all of which is ordinary income.

Example 4. D has ordinary income from a farming business of $200,000 and ordinary loss of $50,000 that is not from a farming or fishing business. D's taxable income is $150,000 ($200,000 − $50,000). Under paragraph (e)(2)(i)(D) of this section, electible farm income may not exceed taxable income. Therefore, D's electible farm income is $150,000, all of which is ordinary income.

Example 5. E has capital gain from a farming business of $50,000, capital loss of $40,000 that is not from a farming or fishing business, and ordinary income from a farming business of $60,000. E's taxable income is $70,000 (($50,000 − $40,000) + $60,000). Under paragraph (e)(2)(i)(D) of this section, electible farm income may not exceed taxable income, and electible farm income from net capital gain attributable to a farming or fishing business may not exceed total net capital gain. Therefore, E's electible farm income is $70,000 of which $10,000 is capital gain and $60,000 is ordinary income.

(f) *Miscellaneous rules*—(1) *Short taxable year*—(i) *In general*. If a base year or an election year is a short taxable year, the rules of section 443 and the regulations thereunder apply for purposes of calculating the section 1 tax.

(ii) *Base year is a short taxable year*. If a base year is a short taxable year, elected farm income is allocated to such year for purposes of paragraph (a)(2) of this section after the taxable income for such year has been annualized.

(iii) *Election year is a short taxable year*. In applying paragraph (a)(2) of this section for purposes of determining tax computed on the annual basis (within the meaning of section

443(b)(1)) for an election year that is a short taxable year—

(A) The taxable income and the electible farm income for the year are annualized; and

(B) The taxpayer may designate all or any part of the annualized electible farm income as elected farm income.

(2) *Changes in filing status.* An individual is not prohibited from making a farm income averaging election solely because the individual's filing status is not the same in an election year and the base years. For example, an individual who is married and files a joint return in the election year, who filed as single in one or more of the base years, may elect to average farm or fishing income, by using the single filing status to compute the increase in section 1 taxes for the base years in which the individual filed as single.

(3) *Employment tax.* A farm income averaging election has no effect in determining the amount of wages for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source on Wages (Federal income tax withholding), or the amount of net earnings from self-employment for purposes of the Self-Employment Contributions Act (SECA).

(4) *Alternative minimum tax.* A farm income averaging election is disregarded in computing the tentative minimum tax and the regular tax under section 55 for the election year or any base year. The election is taken into account, however, in determining the regular tax liability under section 53(c) for the election year.

(5) *Unearned income of minor child.* In an election year, if a minor child's investment income is taxable under section 1(g) and a parent makes a farm income averaging election, the tax rate used for purposes of applying section 1(g) is the rate determined after application of the election. In a base year, however, the tax on a minor child's investment income is not affected by a farm income averaging election.

(g) *Effective/applicability date.* This section applies for taxable years beginning after December 15, 2010. See the provisions of §§ 1.1301–1 and 1.1301–1T as in effect on December 14, 2010 for rules that apply for taxable years beginning on or before December 15, 2010. In addition, a taxpayer may apply paragraph (b)(1)(ii) of this section in taxable years beginning after December 31, 2003.

[T.D. 8972, 67 FR 819, Jan. 8, 2002; 67 FR 5203, Feb. 5, 2002; T.D. 9417, 73 FR 42523, July 22, 2008; T.D. 9509, 75 FR 78157, Dec. 15, 2010]

READJUSTMENT OF TAX BETWEEN YEARS AND SPECIAL LIMITATIONS

MITIGATION OF EFFECT OF LIMITATIONS AND OTHER PROVISIONS

§ 1.1311(a)–1 Introduction.

(a) Part II (section 1311 and following), subchapter Q, chapter 1 of the Code, provides certain rules for the correction of the effect of an erroneous treatment of an item in a taxable year which is closed by the statute of limitations or otherwise, in cases where, in connection with the ascertainment of the tax for another taxable year, it has been determined that there was an erroneous treatment of such item in the closed year.

(b) In most situations falling within this part the correction of the effect of the error on a closed year can be made only if either the Commissioner or the taxpayer has taken a position in another taxable year which is inconsistent with the erroneous treatment of the item in the closed year. If a refund or credit would result from the correction of the error in the closed year, then the Commissioner must be the one maintaining the inconsistent position. For example, if the taxpayer erroneously included an item of income on his return for an earlier year which is now closed and the Commissioner successfully requires it to be included in a later year, then the correction of the effect of the erroneous inclusion of that item in the closed year may be made since the Commissioner has maintained a position inconsistent with the treatment of such item in such closed year. On the other hand, if an additional assessment would result from the correction of the error in the closed year, then the taxpayer must be the one maintaining the inconsistent position. For example, if the taxpayer deducted an item in an earlier year which is now closed and he successfully

contends that the item should be deducted in a later year, then the correction of the effect of the erroneous deduction of that item in the closed year may be made since the taxpayer has taken a position inconsistent with the treatment of such item in such earlier year.

(c) There are two special circumstances which fall within this part but which do not require that an inconsistent position be maintained. One of these circumstances relates to the inclusion of an item of income in the correct year and the other relates to the allowance of a deduction in the correct year. In the first situation, if the Commissioner takes the position by a deficiency notice or before the Tax Court that an item of income should be included in the gross income of a taxpayer for a particular year and it is ultimately determined that such item was not so includible, then such item can be included in the income of the proper year if that year was not closed at the time the Commissioner took his position. In the second situation, if the taxpayer claims that a deduction should be allowed for a particular year and it is ultimately determined that the deduction was not allowable in that year, then the taxpayer may take the deduction in the proper year if that year was not closed at the time the taxpayer first claimed a deduction.

[T.D. 6500, 25 FR 12031, Nov. 26, 1960]

§ 1.1311(a)–2 Purpose and scope of section 1311.

(a) Section 1311 provides for the correction of the effect of certain errors under circumstances specified in section 1312 when one or more provisions of law, such as the statute of limitations, would otherwise prevent such correction. Section 1311 may be applied to correct the effect of certain errors if, on the date of a determination (as defined in section 1313(a) and the regulations thereunder), correction is prevented by the operation of any provision of law other than sections 1311 through 1315 and section 7122 (relating to compromises) and the corresponding provisions of prior revenue laws. Examples of provisions preventing such corrections are sections 6501, 6511, 6532, and 6901 (c), (d) and (e), relating to periods of limitations; section 6212(c) and 6512 relating to the effect of petition to the Tax Court of the United States on further deficiency letters and on credits or refunds; section 7121 relating to closing agreements; and sections 6401 and 6514 relating to payments, refunds, or credits after the period of limitations has expired. Section 1311 may also be applied to correct the effect of an error if, on the date of the determination, correction of the error is prevented by the operation of any rule of law, such as *res judicata* or *estoppel*.

(b) The determination (including a determination under section 1313 (a)(4)) may be with respect to any of the taxes imposed by subtitle A of the Internal Revenue Code of 1954, by chapter 1 and subchapters A, B, D, and E of chapter 2 of the Internal Revenue Code of 1939, or by the corresponding provisions of any prior revenue act, or by more than one of such provisions. Section 1311 may be applied to correct the effect of the error only as to the tax or taxes with respect to which the error was made which correspond to the tax or taxes with respect to which the determination relates. Thus, if the determination relates to a tax imposed by chapter 1 of the Internal Revenue Code of 1954, the adjustment may be only with respect to the tax imposed by such chapter or by the corresponding provisions of prior law.

(c) Section 1311 is not applicable if, on the date of the determination, correction of the effect of the error is permissible without recourse to said section.

(d) If the tax liability for the year with respect to which the error was made has been compromised under section 7122 or the corresponding provisions of prior revenue laws, no adjustment may be made under section 1311 with respect to said year.

(e) No adjustment may be made under section 1311 for any taxable year beginning prior to January 1, 1932. See section 1314(d).

(f) Section 1311 applies only to a determination (as defined in section 1313(a) and §§ 1.1313(a)–1 to 1.1313 (a)–4, inclusive) made after November 14, 1954. Section 3801 of the Internal Revenue Code of 1939 and the regulations thereunder apply to determinations, as

defined therein, made on or before November 14, 1954. See section 1315.

[T.D. 6500, 25 FR 12031, Nov. 26, 1960]

§ 1.1311(b)–1 Maintenance of an inconsistent position.

(a) *In general.* Under the circumstances stated in § 1.1312–1, § 1.1312–2, paragraph (a) of § 1.1312–3, § 1.1312–5, § 1.1312–6, and § 1.1312–7, the maintenance of an inconsistent position is a condition necessary for adjustment. The requirement in such circumstances is that a position maintained with respect to the taxable year of the determination and which is adopted in the determination be inconsistent with the erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, with respect to the taxable year of the error. That is, a position successfully maintained with respect to the taxable year of the determination must be inconsistent with the treatment accorded an item which was the subject of an error in the computation of the tax for the closed taxable year. Adjustments under the circumstances stated in paragraph (b) of § 1.1312–3 and in § 1.1312–4 are made without regard to the maintenance of an inconsistent position.

(b) *Adjustments resulting in refund or credit.* (1) An adjustment under any of the circumstances stated in § 1.1312–1, § 1.1312–5, § 1.1312–6, or § 1.1312–7 which would result in the allowance of a refund or credit is authorized only if (i) the Commissioner, in connection with a determination, has maintained a position which is inconsistent with the erroneous inclusion, omission, disallowance, recognition, or nonrecognition, as the case may be, in the year of the error, and (ii) such inconsistent position is adopted in the determination.

Example: A taxpayer who keeps his books on the cash method erroneously included as income on his return for 1954 an item of accrued interest. After the period of limitations on refunds for 1954 had expired, the district director, on behalf of the Commissioner, proposed an adjustment for the year 1955 on the ground that the item of interest was received in 1955 and, therefore, was properly includible in gross income for that year. The taxpayer and the district director entered into an agreement which meets all of the requirements of § 1.1313(a)–4 and which determines that the interest item was includible in gross income for 1955. The Commissioner has maintained a position inconsistent with the inclusion of the interest item for 1954. As the determination (the agreement pursuant to § 1.1313(a)–4) adopted such inconsistent position, an adjustment is authorized for the year 1954.

(2) An adjustment under circumstances stated in § 1.1312–1, § 1.1312–5, § 1.1312–6, or § 1.1312–7 which would result in the allowance of a refund or credit is not authorized if the taxpayer with respect to whom the determination is made, and not the Commissioner, has maintained such inconsistent position.

Example: In the example in subparagraph (1) of this paragraph, assume that the Commissioner asserted a deficiency for 1955 based upon other items for that year but, in computing the net income upon which such deficiency was based, did not include the item of interest. The taxpayer appealed to the Tax Court and in his petition asserted that the interest item should be included in gross income for 1955. The Tax Court in 1960 included the item of interest in its redetermination of tax for the year 1955. In such case no adjustment would be authorized for 1954 as the taxpayer, and not the Commissioner, maintained a position inconsistent with the erroneous inclusion of the item of interest in the gross income of the taxpayer for that year.

(c) *Adjustments resulting in additional assessments.* (1) An adjustment under any of the circumstances stated in § 1.1312–2, paragraph (a) of § 1.1312–3, § 1.1312–5, § 1.1312–6, or § 1.1312–7 which would result in an additional assessment is authorized only if (i) the taxpayer with respect to whom the determination is made has, in connection therewith, maintained a position which is inconsistent with the erroneous exclusion, omission, allowance, recognition, or nonrecognition, as the case may be, in the year of the error, and (ii) such inconsistent position is adopted in the determination.

Example: A taxpayer in his return for 1950 claimed and was allowed a deduction for a loss arising from a casualty. After the taxpayer had filed his return for 1951 and after the period of limitations upon the assessment of a deficiency for 1950 had expired, it was discovered that the loss actually occurred in 1951. The taxpayer, therefore, filed a claim for refund for the year 1951 based upon the allowance of a deduction for the loss in that year, and the claim was allowed

by the Commissioner in 1955. The taxpayer thus has maintained a position inconsistent with the allowance of the deduction for 1950 by filing a claim for refund for 1951 based upon the same deduction. As the determination (the allowance of the claim for refund) adopts such inconsistent position, an adjustment is authorized for the year 1950.

(2) An adjustment under the circumstances stated in §1.1312–2, paragraph (a) of §1.1312–3, §1.1312–5, §1.1312–6, or §1.1312–7 which would result in an additional assessment is not authorized if the Commissioner, and not the taxpayer, has maintained such inconsistent position.

Example: In the example in subparagraph (1) of this paragraph, assume that the taxpayer did not file a claim for refund for 1951 but the Commissioner issued a notice of deficiency for 1951 based upon other items. The taxpayer filed a petition with the Tax Court of the United States and the Commissioner in his answer voluntarily proposed the allowance for 1951 of a deduction for the loss previously allowed for 1950. The Tax Court took the deduction into account in its redetermination in 1955 of the tax for the year 1951. In such case no adjustment would be authorized for the year 1950 as the Commissioner, and not the taxpayer, has maintained a position inconsistent with the allowance of a deduction for the loss in that year.

[T.D. 6500, 25 FR 12032, Nov. 26, 1960, as amended by T.D. 6617, 27 FR 10823, Nov. 7, 1962]

§ 1.1311(b)–2 Correction not barred at time of erroneous action.

(a) An adjustment under the circumstances stated in paragraph (b) of §1.1312–3 (relating to the double exclusion of an item of gross income) which would result in an additional assessment, is authorized only if assessment of a deficiency against the taxpayer or related taxpayer for the taxable year in which the item is includible was not barred by any law or rule of law at the time the Commissioner first maintained, in a notice of deficiency sent pursuant to section 6212 (or section 272(a) of the Internal Revenue Code of 1939) or before the Tax Court of the United States, that the item described in paragraph (b) of §1.1312–3 should be included in the gross income of the taxpayer in the taxable year to which the determination relates.

(b) An adjustment under the circumstances stated in §1.1312–4 (relating to the double disallowance of a deduction or credit), which would result in the allowance of a credit or refund, is authorized only if a credit or refund to the taxpayer or related taxpayer, attributable to such adjustment, was not barred by any law or rule of law when the taxpayer first maintained in writing before the Commissioner or the Tax Court that he was entitled to such deduction or credit for the taxable year to which the determination relates. The taxpayer will be considered to have first maintained in writing before the Commissioner or the Tax Court that he was entitled to such deduction or credit when he first formally asserts his right to such deduction or credit as, for example, in a return, in a claim for refund, or in a petition (or an amended petition) before the Tax Court.

(c) Under the circumstances of adjustment with respect to which the conditions stated in this section are applicable, the conditions stated in §1.1311(b)–1 (maintenance of an inconsistent position) are not required. See paragraph (b) of §1.1312–3 and §1.1312–4 for examples of the application of this section.

[T.D. 6500, 25 FR 12032, Nov. 26, 1960]

§ 1.1311(b)–3 Existence of relationship in case of adjustment by way of deficiency assessment.

(a) Except for cases described in paragraph (b) of §1.1312–3, no adjustment by way of a deficiency assessment shall be made, with respect to a related taxpayer, unless the relationship existed both at some time during the taxable year with respect to which the error was made and at the time the taxpayer with respect to whom the determination is made first maintained the inconsistent position with respect to the taxable year to which the determination relates. In the case of an adjustment by way of a deficiency assessment under the circumstance described in paragraph (b) of §1.1312–3 (where the maintenance of an inconsistent position is not required), the relationship need exist only at some time during the taxable year in which the error was made.

(b) If the inconsistent position is maintained in a return, claim for refund, or petition (or amended petition)

to the Tax Court of the United States for the taxable year in respect to which the determination is made, the requisite relationship must exist on the date of filing such document. If the inconsistent position is maintained in more than one of such documents, the requisite date is the date of filing of the document in which it was first maintained. If the inconsistent position was not thus maintained, then the relationship must exist on the date of the determination as, for example, where at the instance of the taxpayer a deduction is allowed, the right to which was not asserted in a return, claim for refund, or petition to the Tax Court, and a determination is effected by means of a closing agreement or an agreement under section 1313(a)(4).

[T.D. 6500, 25 FR 12033, Nov. 26, 1960]

§ 1.1312–1 Double inclusion of an item of gross income.

(a) Paragraph (1) of section 1312 applies if the determination requires the inclusion in a taxpayer's gross income of an item which was erroneously included in the gross income of the same taxpayer for another taxable year or of a related taxpayer for the same or another taxable year.

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

Example 1. A taxpayer who keeps his books on the cash method erroneously included in income on his return for 1947 an item of accrued rent. In 1952, after the period of limitation on refunds for 1947 had expired, the Commissioner discovered that the taxpayer received this rent in 1948 and asserted a deficiency for the year 1948 which is sustained by the Tax Court of the United States in 1955. An adjustment in favor of the taxpayer is authorized with respect to the year 1947. If the taxpayer had returned the rent for both 1947 and 1948 and by a determination was denied a refund claim for 1948 on account of the rent item, a similar adjustment is authorized.

Example 2. A husband assigned to his wife salary to be earned by him in the year 1952. The wife included such salary in her separate return for that year and the husband omitted it. The Commissioner asserted a deficiency against the wife for 1952 with respect to a different item; she contested that deficiency, and the Tax Court entered an order in her case which became final in 1955. The wife would therefore be barred by section 6512(a) from claiming a refund for 1952. Thereafter, the Commissioner asserted a deficiency against the husband on account of the omission of such salary from his return for 1952. In 1955 the husband and the Commissioner enter into a closing agreement for the year 1952 in which the salary is taxed to the husband. An adjustment is authorized with respect to the wife's tax for 1952.

[T.D. 6500, 25 FR 12033, Nov. 26, 1960]

§ 1.1312–2 Double allowance of a deduction or credit.

(a) Paragraph (2) of section 1312 applies if the determination allows the taxpayer a deduction or credit which was erroneously allowed the same taxpayer for another taxable year or a related taxpayer for the same or another taxable year.

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

Example 1. A taxpayer in his return for 1950 claimed and was allowed a deduction for destruction of timber by a forest fire. Subsequently, it was discovered that the forest fire occurred in 1951 rather than 1950. After the expiration of the period of limitations for the assessment of a deficiency for 1950, the taxpayer filed a claim for refund for 1951 based upon a deduction for the fire loss in that year. The Commissioner in 1955 allows the claim for refund. An adjustment is authorized with respect to the year 1950.

Example 2. The beneficiary of a testamentary trust in his return for 1949 claimed, and was allowed, a deduction for depreciation of the trust property. The Commissioner asserted a deficiency against the beneficiary for 1949 with respect to a different item and a final decision of the Tax Court of the United States was rendered in 1951, so that the Commissioner was thereafter barred by section 272(f) of the Internal Revenue Code of 1939 from asserting a further deficiency against the beneficiary for 1949. The trustee thereafter filed a timely refund claim contending that, under the terms of the will, the trust, and not the beneficiary, was entitled to the allowance for depreciation. The court in 1955 sustains the refund claim. An adjustment is authorized with respect to the beneficiary's tax for 1949.

[T.D. 6500, 25 FR 12033, Nov. 26, 1960]

§ 1.1312–3 Double exclusion of an item of gross income.

(a) *Items included in income or with respect to which a tax was paid.* (1) Paragraph (3)(A) of section 1312 applies if the determination requires the exclusion, from a taxpayer's gross income,

of an item included in a return filed by the taxpayer, or with respect to which tax was paid, and which was erroneously excluded or omitted from the gross income of the same taxpayer for another taxable year or of a related taxpayer for the same or another taxable year.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. (i) A taxpayer received payments in 1951 under a contract for the performance of services and included the payments in his return for that year. After the expiration of the period of limitations for the assessment of a deficiency for 1950, the Commissioner issued a notice of deficiency to the taxpayer for the year 1951 based upon adjustments to other items, and the taxpayer filed a petition with the Tax Court of the United States and maintained in the proceedings before the Tax Court that he kept his books on the accrual basis and that the payments received in 1951 were on income that had accrued and was properly taxable in 1950. A final decision of the Tax Court was rendered in 1955 excluding the payments from 1951 income. An adjustment in favor of the Commissioner is authorized with respect to the year 1950, whether or not a tax had been paid on the income reported in the 1951 return.

(ii) Assume the same facts as in (i), except that the taxpayer had not included the payments in any return and had not paid a tax thereon. No adjustment would be authorized under section 1312(3)(A) with respect to the year 1950. If the taxpayer, however, had paid a deficiency asserted for 1951 based upon the inclusion of the payments in 1951 income and thereafter successfully sued for refund thereof, an adjustment would be authorized with respect to the year 1950. (See paragraph (b) of this section for circumstances under which correction is authorized with respect to items not included in income and on which a tax was not paid.)

Example 2. A father and son conducted a partnership business, each being entitled to one-half of the net profits. The father included the entire net income of the partnership in his return for 1948, and the son included no portion of this income in his return for that year. Shortly before the expiration of the period of limitations with respect to deficiency assessments and refund claims for both father and son for 1948, the father filed a claim for refund of that portion of his 1948 tax attributable to the half of the partnership income which should have been included in the son's return. The court sustains the claim for refund in 1955. An adjustment is authorized with respect to the son's tax for 1948.

(b) *Items not included in income and with respect to which the tax was not paid.* (1) Paragraph (3)(B) of section 1312 applies if the determination requires the exclusion from gross income of an item not included in a return filed by the taxpayer and with respect to which a tax was not paid, but which is includible in the gross income of the same taxpayer for another taxable year, or in the gross income of a related taxpayer for the same or another taxable year. This is one of the two circumstances in which the maintenance of an inconsistent position is not a requirement for an adjustment, but the requirements in paragraph (a) of § 1.1311(b)–2 must be fulfilled (correction not barred at time of erroneous action).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. The taxpayer, A, who computes his income by use of the accrual method of accounting, performed in 1949 services for which he received payments in 1949 and 1950. He did not include in his return for either 1949 or 1950 the payments which he received in 1950, and he paid no tax with respect to such payments. In 1952 the Commissioner sent a notice of deficiency to A with respect to the year 1949, contending that A should have included all of such payments in his return for that year. A contested the deficiency on the basis that in 1949 he had no accruable right to the payments which he received in 1950. In 1955 (after the expiration of the period of limitations for assessing deficiencies with respect to 1950), the Tax Court sustains A's position. The Commissioner may assess a deficiency for 1950, since a deficiency assessment for that year was not barred when he sent the notice of deficiency with respect to 1949.

Example 2. B and C were partners in 1950, each being entitled to one-half of the profits of the partnership business. During 1950, B received an item of income which he treated as partnership income so that his return for that year reflected only 50 percent of such item. C, however, included no part of such item in any return and paid no tax with respect thereto. In 1952, the Commissioner sent to C a notice of deficiency with respect to 1950, contending that his return for that year should have reflected 50 percent of such item. C contested the deficiency on the basis that such item was not partnership income. In 1955, after the expiration of the period of limitations for assessing deficiencies with respect to 1950, the Tax Court sustained C's

position. The Commissioner may assess a deficiency against B with respect to 1950 requiring him to include the entire amount of such item in his income since assessment of the deficiency was not barred when the Commissioner sent the notice of deficiency with respect to such item to C.

[T.D. 6500, 25 FR 12034, Nov. 26, 1960]

§ 1.1312–4 Double disallowance of a deduction or credit.

(a) Paragraph (4) of section 1312 applies if the determination disallows a deduction or credit which should have been, but was not, allowed to the same taxpayer for another taxable year or to a related taxpayer for the same or another taxable year. This is one of the two circumstances in which the maintenance of an inconsistent position is not a requirement for an adjustment but the requirements in paragraph (b) of § 1.1311(b)–2 must be fulfilled (correction not barred at time of erroneous action).

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

Example 1. The taxpayer, A, who computes his income by use of the accrual method of accounting, deducted in his return for the taxable year 1951 an item of expense which he paid in such year. At the time A filed his return for 1951, the statute of limitations for 1950 had not expired. Subsequently, the Commissioner asserted a deficiency for 1951 based on the position that the liability for such expense should have been accrued for the taxable year 1950. In 1955, after the period of limitations on refunds for 1950 had expired, there was a determination by the Tax Court disallowing such deduction for the taxable year 1951. A is entitled to an adjustment for the taxable year 1950. However, if such liability should have been accrued for the taxable year 1946 instead of 1950, A would not be entitled to an adjustment, if a credit or refund with respect to 1946 was already barred when he deducted such expense for the taxable year 1951.

Example 2. The taxpayer, B, in his return for 1951 claimed a deduction for a charitable contribution. The Commissioner asserted a deficiency for such year contending that 50 percent of the deduction should be disallowed, since the contribution was made from community property 50 percent of which was attributable to B's spouse. The deficiency is sustained by the Tax Court in 1956, subsequent to the period of limitations within which B's spouse could claim a refund with respect to 1951. An adjustment is permitted to B's spouse, a related taxpayer, since a refund attributable to a deduction by her of such contribution was not barred when B claimed the deduction.

[T.D. 6500, 25 FR 12034, Nov. 26, 1960]

§ 1.1312–5 Correlative deductions and inclusions for trusts or estates and legatees, beneficiaries, or heirs.

(a) Paragraph (5) of section 1312 applies to distributions by a trust or an estate to the beneficiaries, heirs, or legatees. If the determination relates to the amount of the deduction allowed by sections 651 and 661 or the inclusion in taxable income of the beneficiary required by sections 652 and 662 (including amounts falling within subpart D, subchapter J, chapter 1 of the Code, relating to treatment of excess distributions by trusts), or if the determination relates to the additional deduction (or inclusion) specified in section 162 (b) and (c) of the Internal Revenue Code of 1939 (or the corresponding provisions of a prior revenue act), with respect to amounts paid, credited, or required to be distributed to the beneficiaries, heirs, and legatees, and such determination requires:

(1) The allowance to the estate or trust of the deduction when such amounts have been erroneously omitted or excluded from the income of the beneficiaries, heirs, or legatees; or

(2) The inclusion of such amounts in the income of the beneficiaries, heirs, or legatees when the deduction has been erroneously disallowed to or omitted by the estate or trust; or

(3) The disallowance to an estate or trust of the deduction when such amounts have been erroneously included in the income of the beneficiaries, heirs, or legatees; or

(4) The exclusion of such amounts from the income of the beneficiaries, heirs, or legatees when the deduction has been erroneously allowed to the estate or trust.

(b) The application of paragraph (a)(1) of this section may be illustrated by the following example:

Example: For the taxable year 1954, a trustee, directed by the trust instrument to accumulate the trust income, made no distribution to the beneficiary and returned the entire income as taxable to the trust. Accordingly the beneficiary did not include the trust income in his return for the year 1954. In 1957, a State court holds invalid the clause

directing accumulation and determines that the income is required to be currently distributed. It also rules that certain extraordinary dividends which the trustee in good faith allocated to corpus in 1954 were properly allocable to income. In 1958, the trustee, relying upon the court decision, files a claim for refund of the tax paid on behalf of the trust for the year 1954 and thereafter files a suit in the District Court. The claim is sustained by the court (except as to the tax on the extraordinary dividends) in 1959 after the expiration of the period of limitations upon deficiency assessments against the beneficiary for the year 1954. An adjustment is authorized with respect to the beneficiary's tax for the year 1954. The treatment of the distribution to the beneficiary of the extraordinary dividends shall be determined under subpart D of subchapter J.

(c) The application of paragraph (a)(2) of this section may be illustrated by the following example:

Example: Assume the same facts as in the example in paragraph (b) of this section, except that, instead of the trustee's filing a refund claim, the Commissioner, relying upon the decision of the State court, asserts a deficiency against the beneficiary for 1954. The deficiency is sustained by final decision of the Tax Court of the United States in 1959, after the expiration of the period for filing claim for refund on behalf of the trust for 1954. An adjustment is authorized with respect to the trust for the year 1954.

(d) The application of paragraph (a)(3) of this section may be illustrated by the following example:

Example: A trustee claimed in the trust return for 1954 for amounts paid to the beneficiary a deduction to the extent of distributable net income. This amount was included by the beneficiary in gross income in his return for 1954. In computing distributable net income the trustee had included short and long-term capital gains. In 1958, the Commissioner asserts a deficiency against the trust on the ground that the capital gains were not includible in distributable net income, and that, therefore, the gains were taxable to the trust, not the beneficiary. The deficiency is sustained by a final decision of the Tax Court in 1960, after the expiration of the period for filing claims for refund by the beneficiary for 1954. An adjustment is authorized with respect to the beneficiary's tax for the year 1954, based on the exclusion from 1954 gross income of the capital gains previously considered distributed by the trust under section 662.

(e) The application of paragraph (a)(4) of this section may be illustrated by the following example:

Example: Assume the same facts as in the example in paragraph (d) of this section, except that, instead of the Commissioner's asserting a deficiency, the beneficiary filed a refund claim for 1954 on the same ground. The claim is sustained by the court in 1960 after the expiration of the period of limitations upon deficiency assessments against the trust for 1954. An adjustment is authorized with respect to the trust for the year 1954.

[T.D. 6500, 25 FR 12034, Nov. 26, 1960]

§ 1.1312–6 Correlative deductions and credits for certain related corporations.

(a) Paragraph (6) of section 1312 applies if the determination allows or disallows a deduction (including a credit) to a corporation, and if a correlative deduction or credit has been erroneously allowed, omitted, or disallowed in respect of a related taxpayer described in section 1313(c)(7).

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

Example 1. X Corporation is a wholly-owned subsidiary of Y Corporation. In 1955, X Corporation paid $5,000 to Y Corporation and claimed an interest deduction for this amount in its return for 1955. Y Corporation included this amount in its gross income for 1955. In 1958, the Commissioner asserted a deficiency against X Corporation for 1955, contending that the deduction for interest paid should be disallowed on the ground that the payment was in reality the payment of a dividend to Y Corporation. X Corporation contested the deficiency, and ultimately in June 1959, a final decision of the Tax Court sustained the Commissioner. Since the amount of the payment is a dividend, Y Corporation should have been allowed for 1955 the corporate dividends-received deduction under section 243 with respect to such payment. However, the Tax Court's decision sustaining the deficiency against X Corporation occurred after the expiration of the period for filing claim for refund by Y Corporation for 1955. An adjustment is authorized with respect to Y Corporation for 1955.

Example 2. Assume the same facts as in example (1) except that, instead of the Commissioner asserting a deficiency against X Corporation for 1955, Y Corporation filed a claim for refund in 1958, alleging that the payment received in 1955 from X Corporation was in reality a dividend to which the corporate dividends-received deduction (section 243) applies. The Commissioner denied the claim, and ultimately in June 1959, the district court, in a final decision, sustained Y

Corporation. Since the amount of the payment is a dividend, X Corporation should not have been allowed an interest deduction for the amount paid to Y Corporation. However, the district court's decision sustaining the claim for refund occurred after the expiration of the period of limitations for assessing a deficiency against X Corporation for the year 1955. An adjustment is authorized with respect to X Corporation's tax for 1955.

[T.D. 6617, 27 FR 10823, Nov. 7, 1962]

§ 1.1312–7 Basis of property after erroneous treatment of a prior transaction.

(a) Paragraph (7) of section 1312 applies if the determination establishes the basis of property, and there occurred one of the following types of errors in respect of a prior transaction upon which such basis depends, or in respect of a prior transaction which was erroneously treated as affecting such basis:

(1) An erroneous inclusion in, or omission from, gross income, or

(2) An erroneous recognition or nonrecognition of gain or loss, or

(3) An erroneous deduction of an item properly chargeable to capital account or an erroneous charge to capital account of an item properly deductible.

(b)(1) For this section to apply, the taxpayer with respect to whom the erroneous treatment occurred must be:

(i) The taxpayer with respect to whom the determination is made; or

(ii) A taxpayer who acquired title to the property in the erroneously treated transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title in such a manner that he will have a basis ascertained by reference to the basis in the hands of the taxpayer who acquired title to the property in the erroneously treated transaction; or

(iii) A taxpayer who had title to the property at the time of the erroneously treated transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, if the basis of the property in the hands of the taxpayer with respect to whom the determination is made is determined under section 1015(a) (relating to the basis of property acquired by gift) or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010).

(2) No adjustment is authorized with respect to the transferor of the property in a transaction upon which the basis of the property depends, when the determination is with respect to the original transferee or a subsequent transferee of the original transferee.

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

Example 1. In 1949 taxpayer A transferred property which had cost him $5,000 to the X Corporation in exchange for an original issue of shares of its stock having a fair market value of $10,000. In his return for 1949 taxpayer A treated the exchange as one in which the gain or loss was not recognizable:

(i) In 1955 the X Corporation maintains that the gain should have been recognized in the exchange in 1949 and therefore the property it received had a $10,000 basis for depreciation. Its position is adopted in a closing agreement. No adjustment is authorized with respect to the tax of the X Corporation for 1949, as none of the three types of errors specified in paragraph (a) of this section occurred with respect to the X Corporation in the treatment of the exchange in 1949. Moreover, no adjustment is authorized with respect to taxpayer A, as he is not within any of the three classes of taxpayers described in paragraph (b) of this section.

(ii) In 1953 taxpayer A sells the stock which he received in 1949 and maintains that, as gain should have been recognized in the exchange in 1949, the basis for computing the profit on the sale is $10,000. His position is confirmed in a closing agreement executed in 1955. An adjustment is authorized with respect to his tax for the year 1949 as the basis for computing the gain on the sale depends upon the transaction in 1949, and in respect of that transaction there was an erroneous nonrecognition of gain to taxpayer A, the taxpayer with respect to whom the determination is made.

Example 2. In 1950 taxpayer A was the owner of 10 shares of the common stock of the Z Corporation which had a basis of $1,500. In that year he received as a dividend thereon 10 shares of the preferred stock of the same corporation having a fair market value of $1,000. On his books, entries were made reducing the basis of the common stock by allocating $500 of the basis to the preferred stock, and on his return for 1950 he did not include the dividend in gross income.

(i) In 1951 taxpayer A made a gift of the preferred stock of the Z Corporation to taxpayer B, an unrelated individual. Taxpayer B sold the stock in 1953 and on his return for that year he reported the sale and claimed a basis of $1,000, contending that the dividend

of preferred stock was taxable to A in 1950 at its fair market value of $1,000. The basis of $1,000 is confirmed by a closing agreement executed in 1955. An adjustment is authorized with respect to taxpayer A's tax for 1950, as the closing agreement determines basis of property, and in a prior transaction upon which such basis depends there was an erroneous omission from gross income of taxpayer A, a taxpayer who acquired title to the property in the erroneously treated transaction and from whom, immediately, the taxpayer with respect to whom the determination is made derived title.

(ii) Assuming the same facts as in (i) except that the common stock instead of the preferred stock was the subject of the gift, and the basis claimed by taxpayer B and confirmed in the closing agreement was $1,500. An adjustment is authorized with respect to taxpayer A's tax for 1950, as the closing agreement determines the basis of property, and in a prior transaction which was erroneously treated as affecting such basis there was an erroneous omission from gross income of taxpayer A, a taxpayer who had title to the property at the time of the erroneously treated transaction, and from whom, immediately, taxpayer B, with respect to whom the determination is made, derived title. The basis of the property in taxpayer B's hands with respect to whom the determination is made is determined under section 1015(a) (relating to the basis of property acquired by gift).

Example 3. In 1950 taxpayer A sold property acquired at a cost of $5,000 to taxpayer B for $10,000. In his return for 1950 taxpayer A failed to include the profit on such sale. In 1953 taxpayer B sold the property for $12,000, and in his return for 1953 reported a gain of $2,000 upon the sale, which is confirmed by a closing agreement executed in 1955. No adjustment is authorized with respect to the tax of taxpayer A for 1950, as he does not come within any of the three classes of taxpayers described in paragraph (b) of this section.

Example 4. In 1950 a taxpayer who owned 100 shares of stock in Corporation Y received $1,000 from the corporation which amount the taxpayer reported on his return for 1950 as a taxable dividend. In 1952 Corporation Y was completely liquidated and the taxpayer received in that year liquidating distributions totalling $8,000. In his return for 1952 the taxpayer reported the receipt of the $8,000 and computed his gain or loss upon the liquidation by using as a basis the amount which he paid for the stock. The Commissioner maintained that the distribution in 1950 was a distribution out of capital and that in computing the taxpayer's gain or loss upon the liquidation in 1952, the basis of the stock should be reduced by the $1,000. This position is adopted in a closing agreement executed in 1955 with respect to the year 1952. An adjustment is authorized with respect to the year 1950 as the basis for computing gain or loss in 1952 depends upon the transaction in 1950, and in respect of the 1950 transaction (upon which the basis of the property depends) there was an erroneous inclusion in gross income of the taxpayer with respect to whom the determination is made.

Example 5. In 1946 a taxpayer received 100 shares of stock of the X Corporation having a fair market value of $5,000, in exchange for shares of stock in the Y Corporation which he had acquired at a cost of $12,000. In his return for 1946 the taxpayer treated the exchange as one in which gain or loss was not recognizable. The taxpayer sold 50 shares of the X Corporation stock in 1947 and in his return for that year treated such shares as having a $6,000 basis. In 1952, the taxpayer sold the remaining 50 shares of stock of the X Corporation for $7,500 and reported $1,500 gain in his return for 1952. After the expiration of the period of limitations on deficiency assessments and on refund claims for 1946 and 1947, the Commissioner asserted a deficiency for 1952 on the ground that the loss realized on the exchange in 1946 was erroneously treated as nonrecognizable, and the basis for computing gain upon the sale in 1952 was $2,500, resulting in a gain of $5,000. The deficiency is sustained by the Tax Court in 1955. An adjustment is authorized with respect to the year 1946 as to the entire $7,000 loss realized on the exchange, as the Court's decision determines the basis of property, and in a prior transaction upon which such basis depends there was an erroneous nonrecognition of loss to the taxpayer with respect to whom the determination was made. No adjustment is authorized with respect to the year 1947 as the basis for computing gain upon the sale of the 50 shares in 1952 does not depend upon the transaction in 1947 but upon the transaction in 1946.

(d) *Effective/applicability date.* This section applies on and after January 19, 2017. For rules before January 19, 2017, see § 1.1312–7 as contained in 26 CFR part 1 revised as of April 1, 2016.

[T.D. 6500, 25 FR 12035, Nov. 26, 1960, as amended by T.D. 6617, 27 FR 10824, Nov. 7, 1962; T.D. 9811, 82 FR 6242, Jan. 19, 2017]

§ 1.1312–8 Law applicable in determination of error.

The question whether there was an erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition is determined under the provisions of the internal revenue laws applicable with respect to the year as to which the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition,

as the case may be, was made. The fact that the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, was in pursuance of an interpretation, either judicial or administrative, accorded such provisions of the internal revenue laws at the time of such action is not necessarily determinative of this question. For example, if a later judicial decision authoritatively alters such interpretation so that such action was contrary to such provisions of the internal revenue laws as later interpreted, the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, is erroneous within the meaning of section 1312.

[T.D. 6500, 25 FR 12036, Nov. 26, 1960. Redesignated by T.D. 6617, 27 FR 10824, Nov. 7, 1962]

§ 1.1313(a)–1 Decision by Tax Court or other court as a determination.

(a) A determination may take the form of a decision by the Tax Court of the United States or a judgment, decree, or other order by any court of competent jurisdiction, which has become final.

(b) The date upon which a decision by the Tax Court becomes final is prescribed in section 7481.

(c) The date upon which a judgment of any other court becomes final must be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no such petition is duly filed within such time.

[T.D. 6500, 25 FR 12036, Nov. 26, 1960]

§ 1.1313(a)–2 Closing agreement as a determination.

A determination may take the form of a closing agreement authorized by section 7121. Such an agreement may relate to the total tax liability of the taxpayer for a particular taxable year or years or to one or more separate items affecting such liability. A closing agreement becomes final for the purpose of this section on the date of its approval by the Commissioner.

[T.D. 6500, 25 FR 12036, Nov. 26, 1960]

§ 1.1313(a)–3 Final disposition of claim for refund as a determination.

(a) *In general.* A determination may take the form of a final disposition of a claim for refund. Such disposition may result in a determination with respect to two classes of items, i.e., items included by the taxpayer in a claim for refund and items applied by the Commissioner to offset the alleged overpayment. The time at which a disposition in respect of a particular item becomes final may depend not only upon what action is taken with respect to that item but also upon whether the claim for refund is allowed or disallowed.

(b) *Items with respect to which the taxpayer's claim is allowed.* (1) The disposition with respect to an item as to which the taxpayer's contention in the claim for refund is sustained becomes final on the date of allowance of the refund or credit if:

(i) The taxpayer's claim for refund is unqualifiedly allowed; or

(ii) The taxpayer's contention with respect to an item is sustained and with respect to other items is denied, so that the net result is an allowance of refund or credit; or

(iii) The taxpayer's contention with respect to an item is sustained, but the Commissioner applies other items to offset the amount of the alleged overpayment and the items so applied do not completely offset such amount but merely reduce it so that the net result is an allowance of refund or credit.

(2) If the taxpayer's contention in the claim for refund with respect to an item is sustained but the Commissioner applies other items to offset the amount of the alleged overpayment so that the net result is a disallowance of the claim for refund, the date of mailing, by registered mail, of the notice of disallowance (see section 6532) is the date of the final disposition as to the item with respect to which the taxpayer's contention is sustained.

(c) *Items with respect to which the taxpayer's claim is disallowed.* The disposition with respect to an item as to which the taxpayer's contention in the

claim for refund is denied becomes final upon the expiration of the time allowed by section 6532 for instituting suit on the claim for refund, unless the suit is instituted prior to the expiration of such period, if:

(1) The taxpayer's claim for refund is unqualifiedly disallowed; or

(2) The taxpayer's contention with respect to an item is denied and with respect to other items is sustained so that the net result is an allowance of refund or credit; or

(3) The taxpayer's contention with respect to an item is sustained in part and denied in part. For example, assume that the taxpayer claimed a deductible loss of $10,000 and a consequent overpayment of $2,500 and the Commissioner concedes that a deductible loss was sustained, but only in the amount of $5,000. The disposition of the claim for refund with respect to the allowance of the $5,000 and the disallowance of the remaining $5,000 becomes final upon the expiration of the time for instituting suit on the claim for refund unless suit is instituted prior to the expiration of such period.

(d) *Items applied by the Commissioner in reduction of the refund or credit.* If the Commissioner applies an item in reduction of the overpayment alleged in the claim for refund, and the net result is an allowance of refund or credit, the disposition with respect to the item so applied by the Commissioner becomes final upon the expiration of the time allowed by section 6532 for instituting suit on the claim for refund, unless suit is instituted prior to the expiration of such period. If such application of the item results in the assertion of a deficiency, such action does not constitute a final disposition of a claim for refund within the meaning of § 1.1313(a)–3, but subsequent action taken with respect to such deficiency may result in a determination under §§ 1.1313(a)–1, 1.1313(a)–2, or 1.1313(a)–4.

(e) *Elimination of waiting period.* The necessity of waiting for the expiration of the 2-year period of limitations provided in section 6532 may be avoided in such cases as are described in paragraph (c) or (d) of this section by the use of a closing agreement (see § 1.1313(a)–2) or agreement under § 1.1313(a)–4 to effect a determination.

[T.D. 6500, 25 FR 12036, Nov. 26, 1960]

§ 1.1313(a)–4 Agreement pursuant to section 1313(a)(4) as a determination.

(a) *In general.* (1) A determination may take the form of an agreement made pursuant to this section. This section is intended to provide an expeditious method for obtaining an adjustment under section 1311 and for offsetting deficiencies and refunds whenever possible. The provisions of part II (section 1311 and following), subchapter Q, chapter 1 of the Code, must be strictly complied with in any such agreement.

(2) An agreement made pursuant to this section will not, in itself, establish the tax liability for the open taxable year to which it relates, but it will state the amount of the tax, as then determined, for such open year. The tax may be the amount of tax shown on the return as filed by the taxpayer, but if any changes in the amount have been made, or if any are being made by documents executed concurrently with the execution of said agreement, such changes must be taken into account. For example, an agreement pursuant to this section may be executed concurrently with the execution of a waiver of restrictions on assessment and collection of a deficiency or acceptance of an overassessment with respect to the open taxable year, or concurrently with the execution and filing of a stipulation in a proceeding before the Tax Court of the United States, where an item which is to be the subject of an adjustment under section 1311 is disposed of by the stipulation and is not left for determination by the court.

(b) *Contents of agreement.* An agreement made pursuant to this section shall be so designated in the heading of the agreement, and it shall contain the following:

(1) A statement of the amount of the tax determined for the open taxable year to which the agreement relates, and if said liability is established or altered by a document executed concurrently with the execution of the agreement, a reference to said document.

(2) A concise statement of the material facts with respect to the item that

was the subject of the error in the closed taxable year or years, and a statement of the manner in which such item was treated in computing the tax liability set forth pursuant to subparagraph (1) of this paragraph.

(3) A statement as to the amount of the adjustment ascertained pursuant to § 1.1314(a)–1 for the taxable year with respect to which the error was made and, where applicable, a statement as to the amount of the adjustment or adjustments ascertained pursuant to § 1.1314(a)–2 with respect to any other taxable year or years; and

(4) A waiver of restrictions on assessment and collection of any deficiencies set forth pursuant to subparagraph 3 of this paragraph.

(c) *Execution and effect of agreement.* An agreement made pursuant to this section shall be signed by the taxpayer with respect to whom the determination is made, or on the taxpayer's behalf by an agent or attorney acting pursuant to a power of attorney on file with the Internal Revenue Service. If an adjustment is to be made in a case of a related taxpayer, the agreement shall be signed also by the related taxpayer, or on the related taxpayer's behalf by an agent or attorney acting pursuant to a power of attorney on file with the Internal Revenue Service. It may be signed on behalf of the Commissioner by the district director, or such other person as is authorized by the Commissioner. When duly executed, such agreement will constitute the authority for an allowance of any refund or credit agreed to therein, and for the immediate assessment of any deficiency agreed to therein for the taxable year with respect to which the error was made, or any closed taxable year or years affected, or treated as affected, by a net operating loss deduction or capital loss carryover determined with reference to the taxable year with respect to which the error was made.

(d) *Finality of determination.* A determination made by an agreement pursuant to this section becomes final when the tax liability for the open taxable year to which the determination relates becomes final. During the period, if any, that a deficiency may be assessed or a refund or credit allowed with respect to such year, either the taxpayer or the Commissioner may properly pursue any of the procedures provided by law to secure a further modification of the tax liability for such year. For example, if the taxpayer subsequently files a claim for refund, or if the Commissioner subsequently issues a notice of deficiency with respect to such year, either may adopt a position with respect to the item that was the subject of the adjustment that is at variance with the manner in which said item was treated in the agreement. Any assessment, refund, or credit that is subsequently made with respect to the tax liability for such open taxable year, to the extent that it is based upon a revision in the treatment of the item that was the subject of the adjustment, shall constitute an alteration or revocation of the determination for the purpose of a redetermination of the adjustment pursuant to paragraph (d) of § 1.1314(b)–1.

[T.D. 6500, 25 FR 12037, Nov. 26, 1960]

§ 1.1313(c)–1 Related taxpayer.

An adjustment in the case of the taxpayer with respect to whom the error was made may be authorized under section 1311 although the determination is made with respect to a different taxpayer, provided that such taxpayers stand in one of the relationships specified in section 1313(c). The concept of *related taxpayer* has application to all of the circumstances of adjustment specified in § 1.1312–1 through § 1.1312–5 if the related taxpayer is one described in section 1313(c); it has application to the circumstances of adjustment specified in § 1.1312–6 only if the related taxpayer is one described in section 1313(c)(7); it does not apply in the circumstances specified in § 1.1312–7. If such relationship exists, it is not essential that the error involve a transaction made possible only by reason of the existence of the relationship. For example, if the error with respect to which an adjustment is sought under section 1311 grew out of an assignment of rents between taxpayer A and taxpayer B, who are partners, and the determination is with respect to taxpayer A, an adjustment with respect to taxpayer B may be permissible despite the fact that the assignment had nothing

to do with the business of the partnership. The relationship need not exist throughout the entire taxable year with respect to which the error was made, but only at some time during that taxable year. For example, if a taxpayer on February 15 assigns to his fiancee the net rents of a building which the taxpayer owns, and the two are married before the end of the taxable year, an adjustment may be permissible if the determination relates to such rents despite the fact that they were not husband and wife at the time of the assignment. See § 1.1311(b)–3 for the requirement in certain cases that the relationship exist at the time an inconsistent position is first maintained.

[T.D. 6617, 27 FR 10824, Nov. 7, 1962]

§ 1.1314(a)–1 Ascertainment of amount of adjustment in year of error.

(a) In computing the amount of the adjustment under sections 1311 to 1315, inclusive, there must first be ascertained the amount of the tax previously determined for the taxpayer as to whom the error was made for the taxable year with respect to which the error was made. The tax previously determined for any taxable year may be the amount of tax shown on the taxpayer's return, but if any changes in that amount have been made, they must be taken into account. In such cases, the tax previously determined will be the sum of the amount shown as the tax by the taxpayer upon his return and the amounts previously assessed (or collected without assessment) as deficiencies, reduced by the amount of any rebates made. The amount shown as the tax by the taxpayer upon his return and the amount of any rebates or deficiencies shall be determined in accordance with the provisions of section 6211 and the regulations thereunder.

(b)(1) The tax previously determined may consist of tax for any taxable year beginning after December 31, 1931, imposed by subtitle A of the Internal Revenue Code of 1954, by chapter 1 and subchapters A, B, D, and E of chapter 2 of the Internal Revenue Code of 1939, or by the corresponding provisions of prior internal revenue laws, or by any one or more of such provisions.

(2) After the tax previously determined has been ascertained, a recomputation must then be made under the laws applicable to said taxable year to ascertain the increase or decrease in tax, if any, resulting from the correction of the error. The difference between the tax previously determined and the tax as recomputed after correction of the error will be the amount of the adjustment.

(c) No change shall be made in the treatment given any item upon which the tax previously determined was based other than in the correction of the item or items with respect to which the error was made. However, due regard shall be given to the effect that such correction may have on the computation of gross income, taxable income, and other matters under chapter 1 of the Code. If the treatment of any item upon which the tax previously determined was based, or if the application of any provisions of the internal revenue laws with respect to such tax, depends upon the amount of income (e.g. charitable contributions, foreign tax credit, dividends received credit, medical expenses, and percentage depletion), readjustment in these particulars will be necessary as part of the recomputation in conformity with the change in the amount of the income which results from the correct treatment of the item or items in respect of which the error was made.

(d) Any interest or additions to the tax collected as a result of the error shall be taken into account in determining the amount of the adjustment.

(e) The application of this section may be illustrated by the following example:

Example: (1) For the taxable year 1949 a taxpayer with no dependents, who kept his books on the cash receipts and disbursements method, filed a joint return with his wife disclosing adjusted gross income of $42,000 deductions amounting to $12,000, and a net income of $30,000. Included among other items in the gross income were salary in the amount of $15,000 and rents accrued but not yet received in the amount of $5,000. During the taxable year he donated $10,000 to the American Red Cross and in his return claimed a deduction of $6,300 on account thereof, representing the maximum deduction allowable under the 15-percent limitation imposed by section 23(o) of the Internal Revenue Code of 1939 as applicable to the

year 1949. In computing his net income he omitted interest income amounting to $6,000 and neglected to take a deduction for interest paid in the amount of $4,500. The return disclosed a tax liability of $7,788, which was assessed and paid. After the expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1949, the Commissioner included the item of rental income amounting to $5,000 in the taxpayer's gross income for the year 1950 and asserted a deficiency for that year. As a result of a final decision of the Tax Court of the United States in 1955 sustaining the deficiency for 1950, an adjustment is authorized for the year 1949.

(2) The amount of the adjustment is computed as follows:

Tax previously determined for 1949	$7,788
Net income for 1949 upon which tax previously determined was based	30,000
Less: Rents erroneously included	5,000
Balance	25,000
Adjustment for contributions (add 15 percent of $5,000)	750
Net income as adjusted	25,750
Tax as recomputed	6,152
Tax previously determined	7,788
Difference	1,636
Amount of adjustment to be refunded or credited	1,636

(3) In accordance with the provisions of paragraph (c) of this section, the recomputation to determine the amount of the adjustment does not take into consideration the item of $6,000 representing interest received, which was omitted from gross income, or the item of $4,500 representing interest paid, for which no deduction was allowed.

[T.D. 6500, 25 FR 12038, Nov. 26, 1960]

§ 1.1314(a)–2 Adjustment to other barred taxable years.

(a) An adjustment is authorized under section 1311 with respect to a taxable year or years other than the year of the error, but only if all of the following requirements are met:

(1) The tax liability for such other year or years must be affected, or must have been treated as affected, by a net operating loss deduction (as defined in section 172) or by a capital loss carryback or carryover (as defined in section 1212).

(2) The net operating loss deduction or capital loss carryback or carryover must be determined with reference to the taxable year with respect to which the error was made.

(3) On the date of the determination the adjustment with respect to such other year or years must be prevented by some law or rule of law, other than sections 1311 through 1315 and section 7122 and the corresponding provisions of prior revenue laws.

(b) The amount of the adjustment for such other year or years shall be computed in a manner similar to that provided in § 1.1314(a)–1. The tax previously determined for such other year or years shall be ascertained. A recomputation must then be made to ascertain the increase or decrease in tax, if any, resulting solely from the correction of the net operating loss deduction or capital loss carryback or carryover. The difference between the tax previously determined and the tax as recomputed is the amount of the adjustment. In the recomputation, no consideration shall be given to items other than the following:

(1) The items upon which the tax previously determined for such other year or years was based, and

(2) The net operating loss deduction or capital loss carryback or carryover as corrected.

In determining the correct net operating loss deduction or capital loss carryback or carryover, no changes shall be made in taxable income (net income in the case of taxable years subject to the provisions of the Internal Revenue Code of 1939 or prior revenue laws), net operating loss or capital loss, for any barred taxable year, except as provided in section 1314. Section 172 and the corresponding provisions of prior revenue laws, and the regulations promulgated thereunder, prescribe the methods of computing the net operating loss deduction. Section 1212 and the corresponding provisions of prior revenue laws, and the regulations promulgated thereunder, prescribe the methods for computing the capital loss carryback and carryover.

(c) A net operating loss deduction or a capital loss carryback or carryover determined with reference to the year of the error may affect, or may have been treated as affecting, a taxable year with respect to which an adjustment is not prevented by the operation of any law or rule of law. In such case,

the appropriate adjustment shall be made with respect to such open taxable year. However, the redetermination of the tax for such open taxable year is not made pursuant to part II (section 1311 and following), subchapter Q, chapter 1 of the Code, and the adjustment for such open year and the method of computation are not limited by the provisions of said sections.

(d) The application of this section may be illustrated by the following example:

Example: The taxpayer is a corporation which makes its income tax returns on a calendar year basis. Its net income in 1949, computed without any net operating loss deduction was $10,000, but because of a net operating loss deduction in excess of that amount resulting from a carryback of a net operating loss claimed for 1950, it paid no income tax for 1949. On its return for 1950 it showed an excess of deductions over gross income of $14,000, and it paid no income tax for 1950. For the year 1951 its net income, computed without any net operating loss deduction, was $15,000, and a net operating loss deduction of $13,000 was allowed ($4,000 of which was attributable to the carryover from 1950 and $9,000 of which was attributable to the carryback of a net operating loss of $9,000 sustained in 1952). In 1957 the assessment of deficiencies or the allowance of refunds for all of said years are barred by the statute of limitations.

(i) A Tax Court decision entered in 1957 with respect to the taxable year 1953 constituted a determination under which an adjustment is authorized to the taxable year 1950, the year with respect to which the error was made. This adjustment increases income for said year by $15,000, so that instead of a net operating loss of $14,000, its corrected net income is $1,000 for 1950, and the tax computed on that income will be assessed as a deficiency for 1950. An adjustment is authorized under this section with respect to each of the years 1949 and 1951, as the tax liability for each year was treated as affected by a net operating loss deduction which was determined by a computation in which reference was made to the year 1950. In the recomputation of the tax for 1949, the net operating loss carryback from 1950 will be eliminated, and in the recomputation of the tax for 1951 the net operating loss carryover from 1950 will be eliminated; for each of the years 1949 and 1951 there will be an adjustment which will be treated as a deficiency for said year.

(ii) Assuming the same facts, except that the correction with respect to the year 1950 increases the net operating loss for said year from $14,000 to $20,000. As a result of this correction, there will be no change in the tax due for 1949 and 1950. However, the net operating loss deduction for 1951 is recomputed to be $19,000, the aggregate of the $10,000 carryover from 1950 and the $9,000 carryback from 1952 (the carryover from 1950 is the excess of the $20,000 net operating loss for 1950 over the $10,000 net income for 1949, such 1949 income being determined without any net operating loss deduction). As a result of the correction of the net operating loss deduction for 1951, the tax recomputation will show no tax due for said year, and the adjustment for 1951 will result in a refund or credit of the tax previously paid. Moreover, computations resulting from this adjustment will disclose a net operating loss carryover from 1952 to 1953 of $4,000, that is, the excess of the $9,000 net operating loss for 1952 over the $5,000 net income for 1951 (such net income for 1951 being computed as the $15,000 reduced by the carryover of $10,000 from 1950, the carryback from 1952 not being taken into account). A further adjustment is authorized under section 1311 with respect to any subsequent barred year in which the tax liability is affected by a carryover of the net operating loss from 1952, inasmuch as such carryover from 1952 has been determined by a computation in which reference was made to 1950, the taxable year of the error.

[T.D. 6500, 25 FR 12038, Nov. 26, 1960, as amended by T.D. 7301, 39 FR 972, Jan. 4, 1974]

§ 1.1314(b)–1 Method of adjustment.

(a) If the amount of the adjustment ascertained pursuant to § 1.1314(a)–1 or § 1.1314(a)–2 represents an increase in tax, it is to be treated as if it were a deficiency determined by the Commissioner with respect to the taxpayer as to whom the error was made and for the taxable year or years with respect to which such adjustment was made. The amount of such adjustment is thus to be assessed and collected under the law and regulations applicable to the assessment and collection of deficiencies, subject, however, to the limitations imposed by § 1.1314(c)–1. Notice of deficiency, unless waived, must be issued with respect to such amount or amounts, and the taxpayer may contest the deficiency before the Tax Court of the United States or, if he chooses, may pay the deficiency and later file claim for refund. If the amount of the adjustment ascertained pursuant to § 1.1314(a)–1 or § 1.1314(a)–2 represents a decrease in tax, it is to be treated as if it were an overpayment claimed by the taxpayer with respect to whom the error was made for the

taxable year or years with respect to which such adjustment was made. Such amount may be recovered under the law and regulations applicable to overpayments of tax, subject, however, to the limitations imposed by § 1.1314(c)–1. The taxpayer must file a claim for refund thereof, unless the overpayment is refunded without such claim, and if the claim is denied or not acted upon by the Commissioner within the prescribed time, the taxpayer may then file suit for refund.

(b) For the purpose of the adjustments authorized by section 1311, the period of limitations upon the making of an assessment or upon refund or credit, as the case may be, for the taxable year of an adjustment shall be considered as if, on the date of the determination, one year remained before the expiration of such period. The Commissioner thus has one year from the date of the determination within which to mail a notice of deficiency in respect of the amount of the adjustment where such adjustment is treated as if it were a deficiency. The issuance of such notice of deficiency, in accordance with the law and regulations applicable to the assessment of deficiencies will suspend the running of the 1-year period of limitations provided in section 1314(b). In accordance with the applicable law and regulations governing the collection of deficiencies, the period of limitation for collection of the amount of the adjustment will commence to run from the date of assessment of such amount. (See section 6502 and corresponding provisions of prior revenue laws.) Similarly, the taxpayer has a period of one year from the date of the determination within which to file a claim for refund in respect of the amount of the adjustment where such adjustment is treated as if it were an overpayment. Where the amount of the adjustment is treated as if it were a deficiency and the taxpayer chooses to pay such deficiency and contest it by way of a claim for refund, the period of limitation upon filing a claim for refund will commence to run from the date of such payment. See section 6511 and corresponding provisions of prior revenue laws.

(c) The amount of an adjustment treated as if it were a deficiency or an overpayment, as the case may be, will bear interest and be subject to additions to the tax to the extent provided by the internal revenue laws applicable to deficiencies and overpayments for the taxable year with respect to which the adjustment is made. In the case of an adjustment resulting from an increase or decrease in a net operating loss or net capital loss which is carried back to the year of adjustment, interest shall not be collected or paid for any period prior to the close of the taxable year in which the net operating loss or net capital loss arises.

(d) If, as a result of a determination provided for in § 1.1313(a)–4, an adjustment has been made by the assessment and collection of a deficiency or the refund or credit of an overpayment, and subsequently such determination is altered or revoked, the amount of the adjustment ascertained under § 1.1314(a)–1 and § 1.1314(a)–2 shall be redetermined on the basis of such alteration or revocation, and any overpayment or deficiency resulting from such redetermination shall be refunded or credited, or assessed and collected, as the case may be, as an adjustment under section 1311. For the circumstances under which such an agreement can be altered or revoked, see paragraph (d) of § 1.1313(a)–4.

[T.D. 6500, 25 FR 12039, Nov. 26, 1960, as amended by T.D. 7301, 39 FR 972, Jan. 4, 1974]

§ 1.1314(c)–1 Adjustment unaffected by other items.

(a) The amount of any adjustment ascertained under § 1.1314(a)–1 or § 1.1314(a)–2 shall not be diminished by any credit or set-off based upon any item other than the one that was the subject of the adjustment.

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

Example 1. In the example set forth in paragraph (e) of § 1.1314(a)–1, if, after the amount of the adjustment had been ascertained, the taxpayer, filed a refund claim for the amount thereof, the Commissioner could not diminish the amount of that claim by offsetting against it the amount of tax which should have been paid with respect to the $6,000 interest item omitted from gross income for the year 1949; nor could the court, if suit were brought on such claim for refund, offset against the amount of the adjustment the

amount of tax which should have been paid with respect to such interest. Similarly, the amount of the refund could not be increased by any amount attributable to the taxpayer's failure to deduct the $4,500 interest paid in the year 1949.

Example 2. Assume that a taxpayer included in his gross income for the year 1953 an item which should have been included in his gross income for the year 1952. After the expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1952, the taxpayer filed a claim for refund for the year 1953 on the ground that such item was not properly includible in gross income for that year. The claim for refund was allowed by the Commissioner and as a result of such determination an adjustment was authorized under section 1311 with respect to the tax for 1952. If, in such case, the Commissioner issued a notice of deficiency for the amount of the adjustment and the taxpayer contested the deficiency before the Tax Court of the United States, the taxpayer could not in such proceeding claim an offset based upon his failure to take an allowable deduction for the year 1952; nor could the Tax Court in its decision offset against the amount of the adjustment any overpayment for the year 1952 resulting from the failure to take such deduction.

(c) If the Commissioner has refunded the amount of an adjustment under section 1311, the amount so refunded may not subsequently be recovered by the Commissioner in any suit for erroneous refund based upon any item other than the one that was the subject of the adjustment,

Example: In the example set forth in paragraph (e) of § 1.1314(a)–1, if the Commissioner had refunded the amount of the adjustment, no part of the amount so refunded could subsequently be recovered by the Commissioner by a suit for erroneous refund based on the ground that there was no overpayment for 1949, as the taxpayer had failed to include in gross income the $6,000 item of interest received in that year.

(d) If the Commissioner has assessed and collected the amount of an adjustment under section 1311, no part thereof may be recovered by the taxpayer in any suit for refund based upon any item other than the one that was the subject of the adjustment.

Example: In example (2) of paragraph (b) of this section, if the taxpayer had paid the amount of the adjustment, he could not subsequently recover any part of such payment in a suit for refund based upon the failure to take an allowable deduction for the year 1952.

(e) If the amount of the adjustment is considered an overpayment, it may be credited, under applicable law and regulations, together with any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made such overpayment. Likewise, if the amount of the adjustment is considered as a deficiency, any overpayment by the taxpayer of any internal revenue tax may be credited against the amount of such adjustment in accordance with the applicable law and regulations thereunder. (See section 6402 and the corresponding provisions of prior revenue laws.) Accordingly, it may be possible in one transaction between the Commissioner and the taxpayer to settle the taxpayer's tax liability for the year with respect to which the determination is made and to make the adjustment under section 1311 for the year with respect to which the error was made or for a year which is affected, or treated as affected, by a net operating loss deduction or a capital loss carryover from the year of the error.

[T.D. 6500, 25 FR 12040, Nov. 26, 1960]

INVOLUNTARY LIQUIDATION AND REPLACEMENT OF LIFO INVENTORIES

§ 1.1321–1 Involuntary liquidation of lifo inventories.

(a) Section 22(d)(6)(B) of the Internal Revenue Code of 1939 provides as follows:

Sec. 22. Gross income. * * *

(d) * * *

(6) *Involuntary liquidation and replacement of inventory.* * * *

(B) *Definition of involuntary liquidation.* The term *involuntary liquidation,* as used in this paragraph, means the sale or other disposition of goods inventoried under the method described in this subsection, either voluntary or involuntary, coupled with a failure on the part of the taxpayer to purchase, manufacture, or otherwise produce and have on hand at the close of the taxable year in which such sale or other disposition occurred such goods as would, if on hand at the close of such taxable year, be subject to the application of the provisions of this subsection, if such failure on the part of the taxpayer is due, directly and exclusively, (i) to enemy

capture or control of sources of limited foreign supply; (ii) to shipping or other transportation shortages; (iii) to material shortages resulting from priorities or allocations; (iv) to labor shortages; or (v) to other prevailing war conditions beyond the control of the taxpayer.

(b)(1) If, during any taxable year ending after June 30, 1950, and before January 1, 1955, the disruption of normal trade relations between countries, or one or more of the conditions attributable to a state of national preparedness and beyond the control of the taxpayer, as prescribed by section 22(d)(6)(B) of the Internal Revenue Code of 1939, as modified by section 1321(b) of the Internal Revenue Code of 1954, should render it impossible during such period for a taxpayer using the last-in first-out inventory method to have on hand at the close of the taxable year a stock of merchandise in kind and description like that included in the opening inventory for the year, or in a quantity equal to that of the opening inventory, the resulting inventory decrease for the year will be regarded, at the election of the taxpayer, as reflecting an involuntary liquidation subject to replacement. If the taxpayer notifies the Commissioner within the period prescribed below that he intends to effect a replacement of the liquidated stock, in whole or in part, and that he desires to have applied in his case the involuntary liquidation and replacement provisions of section 1321, and if he establishes to the satisfaction of the Commissioner the involuntary character of the liquidation to which his stock has been subjected, effect shall be given, when replacement has been made, in whole or in part, but only to the extent made in taxable years ending before January 1, 1956, to an adjustment of taxable income for the year of liquidation in the amount of the difference between the replacement costs incurred and the original inventory cost of the liquidated base stock inventory that is replaced. The notification is to be given within 6 months after the filing by the taxpayer of his income tax return for the year of the liquidation. However, if the liquidation occurs in a taxable year ending after December 31, 1953, the notification may be given at any time within 3 months after the promulgation of regulations under section 1321, or prior to the expiration of the 6-month period following the filing of the return, whichever expiration date later occurs.

(2) If the replacement costs exceed such inventory costs, the taxable income of the taxpayer otherwise computed for the year of liquidation shall be reduced by an amount equal to such excess. If the replacement costs are less than the inventory costs, taxable income otherwise computed for the year of liquidation shall be increased to the extent of such difference. Any deficiency in the income or excess profits tax of the taxpayer, or any overpayment of such taxes, attributable to such adjustment shall be assessed and collected or credited or refunded to the taxpayer without interest.

(c)(1) A failure on the part of the taxpayer to have on hand in his closing inventory for the taxable year merchandise of the kind, description, and quantity of that reflected in his opening inventory will be considered as an involuntary liquidation only if it is established to the satisfaction of the Commissioner that such failure is due wholly to his inability to purchase, manufacture, or otherwise produce and procure delivery of such merchandise during the taxable year of liquidation by reason of the disruption of normal trade relations between countries or by reason of certain war conditions, described in section 22(d)(6)(B) of the Internal Revenue Code of 1939, as modified by section 1321(b). Such war conditions are (i) shortages in the source of foreign supply by reason of capture or control by an enemy; (ii) shipping or other transportation shortages; (iii) material shortages resulting from priorities or allocations; (iv) labor shortages; and (v) similar war conditions beyond the control of the taxpayer. For the purpose of the preceding sentence, the words *enemy* and *war* shall be interpreted to apply to circumstances, occurrences, and conditions lacking a state of war, which are similar, by reason of a state of national preparedness, to those which would exist under a state of war.

(2) The various directives, orders, regulations, and allotments issued by the Federal Government in connection with national preparedness are among

such circumstances and conditions which might be recognized as effecting an involuntary liquidation under this section. Likewise, a voluntary compliance with a request of an authorized representative of the Federal Government made upon an industry or an important segment thereof, or a voluntary allocation of materials by an industry or important segment thereof sanctioned by the Federal Government, if made in connection with the national preparedness program, might be considered as such a circumstance or condition. Similarly, so much of an inventory decrease as is directly and exclusively attributable to the Federal Government's stockpiling program for periods during which an item is not subject to allotment shall also be considered as subject to the provisions of section 1321. Thus, so much of an inventory decrease as is due wholly to the effect of directives, orders, regulations, or allotments issued pursuant to the Defense Production Act of 1950, as amended (50 U.S.C. App. 2061 *et seq.*), or to any other circumstance or condition which is solely dependent upon other action taken by the Federal Government in furtherance of the national preparedness program, ordinarily shall be considered as an involuntary liquidation under section 1321 and this section; however, to the extent that such a decrease is due to the disposition of goods acquired in violation of such directives, orders, regulations, or allotments, such decrease shall not be considered as such an involuntary liquidation. An inventory decrease due directly and exclusively to a disruption of normal trade relations between countries shall be considered as an involuntary liquidation subject to the rules and requirements prescribed in this section, including the requirement that the taxpayer establish to the satisfaction of the Commissioner the cause of the involuntary liquidation. A disruption of normal trade relations between countries may be reflected by unusual export limitations imposed by a foreign government, by unusual exchange restrictions, or by other unusual circumstances or conditions beyond the control of the taxpayer.

(3) A voluntary shift by the taxpayer, in the exercise of business judgment, to merchandise of a different character, description, or use, or to merchandise processed out of a substantially different kind of raw materials while raw materials of the type originally used are still available will not be considered as an involuntary liquidation notwithstanding the fact that such a shift in merchandise stocked was prompted by a shifting market demand attributable to the above conditions. The term *involuntary liquidation* presupposes a physical inability to maintain a normal inventory as distinguished from a financial or business disinclination on the part of the taxpayer to do so.

(d) If the taxpayer would have the involuntary liquidation and replacement provisions applicable with respect to any inventory decrease, he must so elect within the time prescribed by this section. In making such election, the taxpayer shall attach to his return and make a part thereof, or he shall furnish separately to the Commissioner, a statement setting forth the following matters:

(1) The desire of the taxpayer to invoke the involuntary liquidation and replacement provisions;

(2) A detailed list or other identifying description of the items of merchandise claimed to have been subjected to involuntary liquidation and the extent to which replacement is intended;

(3) The circumstances relied upon as rendering the taxpayer unable to maintain throughout the taxable year a normal inventory of the items involved, including evidence of the applicable inventory control figures for the beginning and the close of the taxable year submitted to the appropriate Federal agency in control of defense production (or if none, a statement to that effect), allotments applied for, allotments received, and reason for failure to place allotments received;

(4) Detailed proof of such circumstances to the extent that they may not be the subject-matter of common knowledge;

(5) A full description of what efforts were made on the part of the taxpayer to effect replacement during the taxable year and the result of such efforts; and

(6) In the case of an election made pursuant to an extension of time granted by the Commissioner, the circumstances relied upon as justifying the election at such time, together with a disclosure of the extent, if any, to which replacements have already been made.

(e) The election of the taxpayer to treat an involuntary decrease of inventory as subject to the replacement adjustments is to be exercised separately for each taxable year reflecting such a decrease and the election, once exercised with respect to a given year, shall be irrevocable with respect to the particular decrease involved and its replacement, and shall be binding for the year of liquidation, the year of replacement, and all prior, intervening, and subsequent years to the extent that such prior, intervening, and subsequent years are affected by the adjustments authorized. The ultimate replacement and the resulting adjustment for the year of liquidation may have consequences, among others, in the earnings and profits of intervening years and the inventory accounts of subsequent years. They may have consequences in the prior years by reason of adjustments in net operating loss or unused excess profits credit carrybacks, and in intervening and subsequent taxable years by reason of adjustments in carryovers. Adjustments are to be made for the several years affected consistent with the adjustments made for the year of liquidation. Detailed records shall be maintained such as will enable the Commissioner, in his examination of the taxpayer's return for the year of replacement, readily to verify the extent of the inventory decrease claimed to be involuntary in character and the facts upon which such claim is based, all subsequent inventory increases and decreases, and all other facts material to the replacement adjustment authorized. For taxable years subject to the Internal Revenue Code of 1939, an election under 26 CFR (1939) 39.22(d)–7(e) (Regulations 118) or 26 CFR (1939) 29.22(d)–7 (Regulations 111) to have the involuntary liquidation and replacement provisions of section 22(d)(6) of the Internal Revenue Code of 1939 apply with respect to any inventory decrease for taxable years to which such section applies, shall be given the same effect as if such election had been made under this section. (See section 7807(b)(2).)

(f) Notwithstanding the ultimate purchase price or the cost of production ultimately incurred by the taxpayer in effecting replacement of a stock involuntarily liquidated, the merchandise reflecting the replacement shall be taken into purchases and included in the closing inventory for the year of replacement, and shall be included in the inventories of subsequent taxable years, at the inventory cost figure of the merchandise replaced.

(g) The goods reflected in any inventory increase in a year subsequent to a year of involuntary liquidation, to the extent that they constitute items of the kind and description liquidated in prior years, whether or not in a year of involuntary liquidation, shall be deemed, in the order of their acquisition, as having been acquired by the taxpayer in replacement of like goods most recently liquidated and not previously replaced. In a case involving involuntary liquidations of goods of the same class subject to the provisions of both section 22(d)(6)(A) of the Internal Revenue Code of 1939 and section 1321 of the Internal Revenue Code of 1954, the involuntary liquidations of such goods subject to the provisions of section 1321 shall, for the purpose of replacements made in taxable years ending before January 1, 1953, be considered as having occurred prior to the involuntary liquidations of such goods subject to the provisions of section 22(d)(6)(A) of the Internal Revenue Code of 1939. To the extent that the items of increase are allocated to items liquidated voluntarily, no adjustment will be required or permitted. Such replacement merchandise will be carried in the inventory at its actual cost of acquisition. To the extent that replacements are allocated to items involuntarily liquidated, however, the provisions of this section shall apply, both with respect to adjustments for the year of liquidation and other taxable years affected and with respect to inventory computations for the year of replacement and all subsequent taxable years.

(h) In some cases it may appear that, at the time of the filing of the income tax return for the year of replacement, or within three years thereafter, an adjustment with respect to the income or excess profits taxes for the year of the involuntary liquidation, or for some prior, intervening, or subsequent taxable year, is prevented by the running of the statute of limitations, by the execution of a closing agreement, by virtue of a court decision which has become final, or by reason of some other provision or rule of law other than section 7122 (relating to compromises) and other than the inventory replacement provisions. The adjustments provided for in connection with the involuntary liquidation and replacement of inventory shall nevertheless be made, but only if, within a period of three years after the date of the filing of the income tax return for the year of replacement, a notice of deficiency is mailed or a claim for refund is filed. No credit or refund will be allowed under such circumstances, whether within or without such three-year period, in the absence of a claim for refund duly filed; nor will a resulting deficiency be assessed or collected under section 6213(d) relating to waivers of restrictions. The issuance of the statutory notice of deficiency or the filing of a claim for refund are statutory conditions upon which depend the provisions of section 22(d)(6)(E) of the Internal Revenue Code of 1939, referred to in section 1321(c) of the Internal Revenue Code of 1954. The adjustment authorized by section 22(d)(6)(E) of the Internal Revenue Code of 1939 is limited further to the tax attributable solely to the replacement adjustments. The amount of the adjustment shall be computed by reference to the amount of the tax previously determined, and without regard to factors affecting the taxable year involved to which no effect was given in such prior determination. The tax previously determined shall be ascertained in accordance with the principles stated in section 452(d) of the Internal Revenue Code of 1939. Any deficiency paid or any overpayment credited or refunded under these circumstances shall not be subject to recovery on a claim for refund or a suit for the recovery of an erroneous refund in any case in which such claim or suit is based upon factors other than those giving rise to the adjustments made.

[T.D. 6500, 25 FR 12040, Nov. 26, 1960]

§ 1.1321–2 Liquidation and replacement of lifo inventories by acquiring corporations.

For additional rules in the case of certain corporate acquisitions referred to in section 381(a), see section 381(c)(5) and the regulations thereunder.

[T.D. 6500, 25 FR 12042, Nov. 26, 1960]

WAR LOSS RECOVERIES

§ 1.1331–1 Recoveries in respect of war losses.

(a)(1) The amount of any recovery in respect of *war loss property* must be included in gross income to the extent provided in section 1332 unless, pursuant to the taxpayer's election under section 1335, the provisions of section 1333 are applicable to such recovery. For the treatment of war loss recoveries under section 1333 and the manner of making the election under section 1335, see §§ 1.1333–1 and 1.1335–1.

(2) As used in this part, the term *war loss property* means property considered under section 127(a) of the Internal Revenue Code of 1939 as *destroyed or seized,* including any interest described in section 127(a)(3) of the Internal Revenue Code of 1939.

(3) For regulations governing the treatment of war losses under the Internal Revenue Code of 1939, see 26 CFR (1939) 29.127(a)–1 to 29.127(a)–4, inclusive, 29.127(b)–1, and 29.127(e)–1 (Regulations 111) and 26 CFR (1939) 39.127(a)–1 (Regulations 118).

(b) The recoveries in respect of any war loss property include the recovery of the same war loss property and the recovery of any money or property in lieu of such property or on account of the destruction or seizure of such property. For example, there is a recovery upon the return to the taxpayer after the termination of the war of his property which was treated as war loss property because it was located in a country at war with the United States. An award by a government on account of the seizure of the taxpayer's property by an enemy country is a recovery

under this section. The amount obtained upon the sale or other transfer by the taxpayer of his right to any war loss property is also a recovery for the purpose of this section. Similarly, if a taxpayer who sustained a war loss upon the liquidation of a corporation has received the rights to any property of the corporation which was treated as war loss property, any recovery by the taxpayer with respect to such rights is a recovery by him for the purposes of this section.

(c) For the purpose of this section, the recoveries considered are only those with respect to war losses sustained in prior taxable years. Similarly, the only deductions considered are those allowable for prior taxable years, and any allowable deductions for the year of the recovery are ignored for the purposes of applying such section to the recovery.

(d) If a deduction was claimed under section 127(a) of the Internal Revenue Code of 1939 by a taxpayer in computing his tax for any taxable year and if such deduction was disallowed in whole or in part, any recovery in respect of the portion disallowed shall not be subject to the provisions of part IV (section 1331 and following), subchapter Q, chapter 1 of the Code.

[T.D. 6500, 25 FR 12042, Nov. 26, 1960]

§ 1.1332–1 Inclusion in gross income of war loss recoveries.

(a) *Amount of recovery*. Except as provided in section 1333(1), the amount of the recovery in respect of a war loss in a previous taxable year is determined in the same manner for the purpose of either section 1332 or 1333. The amount of the recovery of any money or property in respect of any war loss is the aggregate of the amount of such money and of the fair market value of such property, both determined as of the date of the recovery. But see paragraph (a) of § 1.1333–1 for optional valuation where the taxpayer recovers the same war loss property.

(b) *Amount of gain includible*. (1) A taxpayer who has sustained a war loss described in section 127(a) of the Internal Revenue Code of 1939 and who has not elected to have the provisions of section 1333 apply to any taxable year in which he recovered any money or property in respect of a war loss in any previous taxable year must include in his gross income for each taxable year, to the extent provided in section 1332, the amount of his recoveries of money and property for such taxable year in respect of any war loss in a previous taxable year. Section 1332 provides that such recoveries for any taxable year are not includible in income until the taxpayer has recovered an amount equal to his allowable deductions in prior taxable years on account of such war losses which did not result in a reduction of any tax under chapter 1 or 2 of the Internal Revenue Code of 1939. War loss recoveries are considered as made first on account of war losses allowable but not actually allowed as a deduction, and second on account of war losses allowed as a deduction but which did not result in a reduction of tax under chapter 1 or 2 of the Internal Revenue Code of 1939. If there were deductions allowed on account of war losses for two or more taxable years which did not result in a reduction of any tax under chapter 1 or 2 of the Internal Revenue Code of 1939, a recovery on account of such losses is considered as made on account of such losses in the order of the taxable years for which they were allowed beginning with the latest. See § 1.1337–1 for the determination of the amount of such deductions. Recoveries in excess of such amount are treated as ordinary income until such excess equals the amount of the taxpayer's allowable deductions in prior taxable years on account of war losses which did result in a reduction of any such tax under chapter 1 or 2 of the Internal Revenue Code of 1939. Any further recoveries in excess of all the taxpayer's allowable deductions in prior taxable years for war losses are treated as gain on an involuntary conversion of property as a result of its destruction or seizure, and such gain is recognized or not recognized under the provisions of section 1033. See section 1033 and the regulations thereunder. Such gain, if recognized, is included in gross income as ordinary income unless section 1231(a) applies to cause such gain to be treated as gain from the sale or exchange of a capital asset held for more than six months. See section 1231(a) and the regulations thereunder.

(2) The determination as to whether and to what extent any recoveries are to be included in gross income is made upon the basis of the amount of all the recoveries for each day upon which there are any such recoveries, as follows:

(i) The amount of the recoveries for any day is not included in gross income, and is not considered gain on an involuntary conversion, to the extent, if any, that the aggregate of the allowable deductions in prior taxable years on account of war losses which did not result in a reduction of any tax of the taxpayer under chapter 1 or 2 of the Internal Revenue Code of 1939, as determined under § 1.1337–1, exceeds the amount of all previous recoveries in the same and prior taxable years.

(ii) The amount of the recoveries for any day which is not excluded from gross income under subdivision (i) of this subparagraph is included in gross income as ordinary income, and is not considered gain on an involuntary conversion, to the extent, if any, that the aggregate of all the allowable deductions in prior taxable years on account of war losses (both those which resulted in a reduction of a tax of the taxpayer and those which did not) exceeds the sum of the amount of all previous recoveries in the same and prior taxable years and of that portion, if any, of the amount of the recoveries for such day which is not included in gross income under subdivision (i) of this subparagraph.

(iii) The amount of the recoveries for any day which is not excluded from gross income under subdivision (i) of this subparagraph and is not included in gross income as ordinary income under subdivision (ii) of this subparagraph is considered gain on an involuntary conversion of property as a result of its destruction or seizure. The following provisions then apply to this gain:

(*a*) Such gain is recognized or not recognized under the provisions of section 1033, relating to gain on the involuntary conversion of property. For the purpose of applying section 1033, such gain for any day is deemed to be expended in the manner provided in section 1033 to the extent the recovery for such day is so expended.

(*b*) If such gain is recognized, it is included in gross income as ordinary income or, if the provisions of section 1231(a) apply and require such treatment, as gain on the sale or exchange of a capital asset held for more than six months. For the purpose of applying section 1231(a), such recognized gain for any day is deemed to be derived from property described in that section to the extent of the recovery for such day with respect to such property, except such portion of such recovery as is attributable to the nonrecognized gain for such day.

(*c*) Section 1336 provides that in determining the unadjusted basis of recovered property, the total gain and the recognized gain with respect to such property must be determined. For such purpose, the recognized gain deemed to be derived from properties described in section 1231(a) may be allocated among such properties in the proportion of the recoveries with respect to such properties, reduced for each property by the portion of the recovery attributable to the nonrecognized gain for such day, and the recoveries with respect to properties not described in section 1231(a) may be similarly allocated. The total gain derived from any recovered property is the sum of the nonrecognized gain attributable to the recovery of such property and of the recognized gain allocable to such property.

(3) The foregoing provisions may be illustrated by the following examples:

Example 1. The taxpayer sustained war losses of $3,000 on account of properties A, B, C, and D. Of this amount, $1,000 did not result in a reduction of any income tax of the taxpayer, as determined under the provisions of § 1.1337–1. In a subsequent taxable year, he received an award of $800 from the Government on account of property A. This is not included in income since it is less than the amount by which his allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit ($1,000) exceed $0, the sum of all his previous recoveries. On a later date the taxpayer recovers property B, which is worth $1,500 on the date of recovery. This recovery is not included in gross income to the extent of $200, the amount by which the aggregate of the allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit ($1,000) exceeds the sum of all previous recoveries ($800). The remaining

$1,300 of the recovery is included in gross income as ordinary income, and is not considered gain on the involuntary conversion of property, since it is less than the amount by which the aggregate of all the allowable deductions in prior taxable years on account of war losses ($3,000) exceeds $1,000, the sum of the $800 of previous recoveries and of the $200 portion of the recovery with respect to B which is not included in gross income. On a still later date the taxpayer sells for $2,500 his rights to recover C. Since the allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit ($1,000) do not exceed the previous recoveries by the taxpayer ($800 and $1,500, or $2,300), none of the recovery on account of C is excluded from gross income. This recovery is included in gross income as ordinary income, and is not considered gain on the involuntary conversion of property, to the extent of $700, the amount by which the aggregate of all the allowable deductions for prior taxable years on account of war losses ($3,000) exceeds $2,300, the sum of the $2,300 of previous recoveries and of the $0 portion of the recovery on account of C which is not included in gross income. The remaining $1,800 of the recovery is considered gain on an involuntary conversion of property on account of its destruction or seizure, and is not recognized if forthwith expended in the manner provided in section 1033. Thus, it is not recognized if it is forthwith expended for the acquisition of property related in service or use to C. On a later date the taxpayer recovers D, which has a fair market value of $400 at the time of the recovery. Since the aggregate of all the allowable deductions for prior taxable years on account of war losses ($3,000) does not exceed the previous recoveries by the taxpayer ($800 + $1,500 + $2,500, or $4,800), all of the recovery with respect to D is considered gain on an involuntary conversion of property as a result of its destruction or seizure. Under the provisions of section 1033, this gain is not recognized if D is used for the same purposes for which it was used before it was deemed destroyed or seized under section 127(a) of the Internal Revenue Code of 1939.

Example 2. The taxpayer on one day recovers $3,000 for property A and $7,000 for property B, both of which were treated as war loss property for a prior taxable year, and $8,000 of such $10,000 recoveries is considered gain on the involuntary conversion of property as a result of its destruction or seizure. The taxpayer forthwith expends $5,000 in the acquisition of property similar in use to B. Therefore, $5,000 of the $8,000 gain is not recognized under section 1033, leaving $3,000 of recognized gain. Property B is within the provisions of section 1231(a), relating to gains and losses on the involuntary conversion of certain described property, but property A is not. Therefore, the provisions of section 1231(a) apply to $2,000 of the $3,000 gain, that is, the amount of the recovery with respect to B which is not attributable to the nonrecognized gain for such day ($7,000 minus $5,000). If the taxpayer forthwith expended $8,000 or more for the acquisition of property similar in use to B, none of the gain would be recognized. If the taxpayer forthwith expended the $5,000 to acquire property related in use to A, the $3,000 recognized gain would be considered derived from B to the extent of the recovery with respect to B ($7,000), not reduced by any nonrecognized gain since none of such recovery is attributable to such nonrecognized gain, and therefore all of the $3,000 recognized gain would be subject to the provisions of section 1231(a).

(4) An allowable deduction with respect to a war loss is any deduction to which the taxpayer is entitled on account of any war loss property, regardless of whether or not such deduction was claimed by the taxpayer or otherwise allowed in computing his tax. If a deduction was claimed by a taxpayer in computing his tax for any taxable year and if such deduction was disallowed, such deduction will not be considered an allowable deduction for such taxable year since the previous determination will not be reconsidered.

[T.D. 6500, 25 FR 12043, Nov. 26, 1960]

§ 1.1333–1 Tax adjustment measured by prior benefits.

(a) *Amount of recovery.* The amount of recovery for purposes of this section shall be determined in accordance with the provisions of section 1332(a). See paragraph (a) of § 1.1332–1. If, pursuant to the taxpayer's election under section 1335, the provisions of section 1333 are applicable to any taxable year in which he recovers the same war loss property, the fair market value of such property shall, at the option of the taxpayer, be considered an amount equal to the adjusted basis (for determining loss) of such property in the hands of the taxpayer on the date such property was considered as destroyed or seized. This option is exercisable by the taxpayer with respect to each separate war loss property. Also, if the provisions of section 1333 are applicable pursuant to the taxpayer's election, the amount of the recovery of any money or property in respect of war loss property shall be reduced for the purpose of

section 1333 (2) and (3) by the amount of the obligations or liabilities with respect to such property, if the taxpayer for any previous taxable year chose under section 127(b)(2) of the Internal Revenue Code of 1939 to treat such obligations or liabilities as discharged or satisfied out of such property, and such obligations or liabilities were not so discharged or satisfied before the date of the recovery. See 26 CFR (1939) 29.127(b)–1 (Regulations 111).

(b) *Elective method; tax adjustment measured by prior benefits.* (1) If the taxpayer elects pursuant to section 1335 and in accordance with the provisions of §1.1335–1 to have the provisions of section 1333 apply to any taxable year in which he recovers any money or property in respect of war loss property, the amount of the recovery in respect of such property for any taxable year shall not be included in income until the taxpayer has recovered an amount equal to his allowable deductions in prior taxable years on account of the destruction or seizure of such property, whether or not such allowable deductions resulted in a reduction of any tax under chapter 1 or 2 of the Internal Revenue Code of 1939. However, for the purposes of section 6012(a)(1), relating to the requirement of individual returns, section 6012(a)(2), relating to the requirement of corporation returns, and section 1312, relating to the mitigation of the effect of the statute of limitations, the entire amount of the recovery shall be deemed to be an item includible in gross income for the taxable year in which the recovery is made. In lieu of including such amount in gross income, there shall be added to, and assessed and collected as a part of, the tax imposed under subtitle A of the Internal Revenue Code of 1954 for the taxable year of the recovery an adjustment on account of any tax benefits in all prior taxable years resulting directly or indirectly from the fact that the loss from the destruction or seizure of such property was an allowable deduction. The amount of such adjustment shall be the total increase in the tax under chapters 1 and 2 of the Internal Revenue Code of 1939 for all taxable years which would result by decreasing such allowable deductions with respect to the destruction or seizure of such property by an amount equal to that portion of the amount of the recovery which is not included in gross income for the taxable year of the recovery. The portion of the amount of the recovery which is in excess of such allowable deductions is included in gross income for the taxable year of the recovery as gain on the involuntary conversion of property as a result of its destruction or seizure and is recognized or not recognized as provided in section 1033. See section 1033 and the regulations thereunder. Such gain, if recognized, is included in gross income as ordinary income unless section 1231(a) applies to cause such gain to be treated as gain on the sale or exchange of capital assets held for more than six months. See section 1231(a) and the regulations thereunder.

(2) The determination as to whether and to what extent the amount of the recovery is to be excluded from gross income is to be made upon the basis of the total amount of the recoveries in each taxable year in respect of the same war loss property, as follows:

(i) The amount of the recovery in any taxable year is excluded from the gross income of such year and is not considered gain on an involuntary conversion to the extent that such amount does not exceed the aggregate of the allowable deductions in prior taxable years on account of the destruction or seizure of such property (whether or not such deductions resulted in a reduction of a tax of the taxpayer) reduced by the aggregate amount of any recoveries in intervening taxable years in respect of the same property.

(ii) The amount of the recovery in any taxable year which is not excluded from gross income under subdivision (i) of this subparagraph is included in gross income and is considered gain on an involuntary conversion of property as a result of its destruction or seizure. The following provisions apply to this gain:

(*a*) Such gain is recognized or not recognized under the provisions of section 1033, relating to gain on the involuntary conversion of property. For the purpose of applying section 1033, such gain for any taxable year is deemed to be expended in the manner provided in

section 1033 to the extent the recovery in such taxable year is so expended.

(*b*) If such gain is recognized it is included in gross income as ordinary income or, if the provisions of section 1231(a) apply and require such treatment, as gain on the sale or exchange of a capital asset held for more than six months. In the case of the recovery of the same war loss property, any gain will not be deemed to be recognized under the provisions of section 1231(a) if such property is used for the same purpose for which it was used before it was deemed destroyed or seized under section 127(a) of the Internal Revenue Code of 1939.

(3) The determination of the total increase in the tax under chapters 1 and 2 of the Internal Revenue Code of 1939 for all taxable years which would result by decreasing the deductions allowable in any prior taxable year with respect to the destruction or seizure of the property in respect of which the taxpayer has made a recovery by an amount equal to the part of such recovery not included in gross income for the taxable year of such recovery shall be made as provided in this subparagraph. Such total increase shall include the increases described in subdivisions (i), (ii), (iii), and (iv) of this subparagraph, and shall be added to, and assessed and collected as a part of, the tax under subtitle A for the taxable year of the recovery. Proper adjustment of such increases shall be made on account of the application of the provisions of this subparagraph to intervening taxable years. Proper adjustment shall also be made in the determination of such increases in the case of a taxpayer who has made a valid election under section 1020, relating to the adjustment of basis of property for depreciation, obsolescence, amortization, and depletion. The term *tax previously determined* as used in this subparagraph shall have the same meaning as used in section 1314(a) and shall include any tax under chapter 1 or 2 of the Internal Revenue Code of 1939. In computing the amount of the increase in the tax previously determined under chapter 1 or 2 of the Internal Revenue Code of 1939 for any taxable year, the principles of section 1314(a) shall be applicable. See section 1314(a) and the regulations thereunder. However, the computation of the excess profits credit under chapter 2E of the Internal Revenue Code of 1939 for any taxable year shall not be affected by the adjustment provided in this subparagraph. All credits allowable against the tax for any year shall be taken into account in computing the increase in the tax previously determined. The increases referred to above include the following:

(i) The increase, if any, in the tax previously determined for each prior taxable year in which a deduction was allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year. After the tax previously determined has been ascertained, such tax shall be recomputed by disregarding such allowable deduction (to the extent that it does not exceed the sum of the amount of such recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and any other deductions allowable on account of other war losses or any other losses, expenditures or accruals in such prior taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127(c)(3) or section 22(b)(12) of the Internal Revenue Code of 1939, or section 1333 or section 111 of the Internal Revenue Code of 1954, or otherwise. The difference between the tax previously determined and the tax as recomputed will be the increase in the tax previously determined for the taxable year.

(ii) The increase, if any, in the tax previously determined for any taxable year (including the taxable year of the recovery) in which a net operating loss deduction was allowable, if all or a part of such deduction was attributable to the carryover or carryback to such taxable year of a net operating loss from another taxable year in which a deduction was allowable on account of the destruction or seizure of the property in respect of which there is a recovery

in the taxable year to which such increase is to be added. After the tax previously determined has been ascertained, such tax shall be recomputed by redetermining such net operating loss deduction. In the determination of such net operating loss deduction the net operating loss shall be recomputed by disregarding the deduction allowable on account of the war loss in respect of which there is a recovery in the taxable year to which such increase is to be added (to the extent that such deduction does not exceed the sum of the amount of such recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and by disregarding any other deductions allowable on account of other war losses or any other losses, expenditures, or accruals in the taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127(c)(3) or 22(b)(12) of the Internal Revenue Code of 1939, or section 1333 or 111 of the Internal Revenue Code of 1954, or otherwise. The difference between the tax previously determined and the tax as recomputed will be the increase in the tax previously determined for the taxable year.

(iii) The increase, if any, in the tax previously determined for any taxable year (including the taxable year of recovery) in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment for such taxable year, if all or a part of such adjustment was attributable to the carryover or carryback to such taxable year of an unused excess profits credit from another taxable year in which a deduction was allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year to which such increase is to be added. After the tax previously determined has been ascertained, such tax shall be recomputed by redetermining such unused excess profits credit carryover or carryback. In the recomputation such carryover or carryback shall be redetermined by disregarding such allowable war loss deduction (to the extent such deduction does not exceed the sum of the amount of the recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and by disregarding any other deductions allowable on account of other war losses or any other losses, expenditures, or accruals in the taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127(c)(3) or 22(b)(12) of the Internal Revenue Code of 1939, or section 1333 or 111 of the Internal Revenue Code of 1954, or otherwise. The difference between the tax previously determined and the tax as recomputed will be the increase in the tax previously determined for the taxable year. In case there is an increase in the excess profits tax under chapter 2E of the Internal Revenue Code of 1939 for the taxable year in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment, and a decrease in the income tax under chapter 1 of the Internal Revenue Code of 1939 for such taxable year, the increase in the tax previously determined shall be considered to be an amount equal to the excess of the increase in the excess profits tax over the decrease in the income tax.

(iv) The increase, if any, in the tax previously determined for any taxable year (including the taxable year of the recovery) in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment for such taxable year, if all or a part of such adjustment was attributable to the carryover or carryback to such taxable year of an unused excess profits credit from another taxable year in which there was allowable a net operating loss deduction attributable to the carryover or carryback to such other taxable year of a net operating loss, and such net operating loss resulted in whole or in part from the deduction allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year to

which such increase is to be added. After the tax previously determined has been ascertained, such tax shall be recomputed by redetermining such net operating loss deduction and such unused excess profits credit carryover or carryback. In the redetermination of such net operating loss deduction the net operating loss carryover or carryback shall be recomputed by disregarding such allowable war loss deduction (to the extent that such deduction does not exceed the sum of the amount of such recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and by disregarding any other deductions allowable on account of other war losses or any other losses, expenditures, or accruals in the taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127(c)(3) or 22(b)(12) of the Internal Revenue Code of 1939, or section 1333 or 111 of the Internal Revenue Code of 1954, or otherwise. The unused excess profits credit carryover or carryback shall then be recomputed to conform to the redetermination of the net operating loss deduction for the taxable year from which the unused credit is carried over or carried back. The difference between the tax previously determined and the tax as recomputed shall be the amount of the increase which shall be added to the tax for the taxable year of the recovery. In case there is an increase in the excess profits tax under chapter 2E of the Internal Revenue Code of 1939 for the taxable year in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment, and a decrease in the income tax under chapter 1 of the Internal Revenue Code of 1939 for such taxable year, the increase which shall be added to the tax for the taxable year of the recovery shall be considered to be an amount equal to the excess of the increase in the excess profits tax over the decrease in the income tax.

[T.D. 6500, 25 FR 12045, Nov. 26, 1960]

§ 1.1334–1 Restoration of value of investments.

If any interest of the taxpayer in or with respect to property was determined to be worthless and was treated as a war loss under section 127(a)(3) of the Internal Revenue Code of 1939 (see 26 CFR (1939) 29.127(a)–4) (Regulations 111), or if the taxpayer retained an interest in a corporation with respect to which he sustained a war loss under section 127(e) of the Internal Revenue Code of 1939, and if the interest in the hands of the taxpayer is restored in value, in whole or in part, by reason of a recovery with respect to the underlying assets treated as war loss property, then such restoration in value is a recovery by the taxpayer for the purposes of section 1331. In the application of section 1333, such restoration shall be treated as a recovery of the same interest considered as destroyed or seized. War loss property is considered as not being in existence from the date of the loss to the date of its recovery.

[T.D. 6500, 25 FR 12046, Nov. 26, 1960]

§ 1.1335–1 Elective method; time and manner of making election and effect thereof.

(a) *In general*. If the taxpayer elects to have the provisions of section 1333 applicable to any taxable year in which any money or property is recovered in respect of war loss property, section 1333 will be applicable by virtue of that election to all taxable years of the taxpayer beginning after December 31, 1941. Thus, the taxpayer need not make an election with respect to each separate taxable year in which he had a recovery. An election for any taxable year in which the taxpayer had a recovery in respect of a prior war loss is sufficient to make the provisions of section 1333 applicable not only to war loss recoveries received by the taxpayer in any past taxable year beginning after December 31, 1941, but to any recoveries which may be received by the taxpayer in any future taxable year. Such election once made shall be irrevocable. The election to have the provisions of section 1333 applicable to any taxable year cannot be made unless the taxpayer recovers money or property (in respect of a prior war loss)

during the taxable year for which such election is made.

(b) *Manner of election.* In all cases the election to have the provisions of section 1333 apply must be made by the taxpayer not later than six months from the last day prescribed by law for the filing of his income tax return for any taxable year in which a recovery of war loss property has occurred. The election shall be evidenced by a written statement, made within such 6-month period, that the taxpayer elects to have the provisions of section 1333 apply to any taxable year in which any money or property is recovered in respect of war loss property. The statement may be made in (or attached to):

(1) The return or amended return filed for such taxable year;

(2) A claim for refund or credit filed for such taxable year for an overpayment resulting from application of such provisions;

(3) A timely petition or amended petition to The Tax Court of the United States for a redetermination of any deficiency for any taxable year in which a recovery of war loss property occurred; or

(4) A letter addressed to the district director for the district in which the return for such taxable year was required to be filed.

If the written statement of election is made in a letter, it shall be signed by the taxpayer making the election if an individual or, if the taxpayer is not an individual, the letter must be executed in the same manner as required in the case of the income tax return of such taxpayer. The date of the making of the election shall be the date the return, amended return, claim for refund or credit, or letter is filed in the office of the district director, or the date the petition or amended petition is filed with The Tax Court of the United States. In case the election is made in a return filed before the last day prescribed by law for the filing thereof (including any extension of time for such filing), such election shall not be considered made until such last day. See section 7502 and the regulations thereunder with respect to the timeliness of filing an election where filing is done by mail and section 7503 and the regulations thereunder with respect to the timeliness of filing where the last day for filing falls on a Saturday, Sunday, or legal holiday.

(c) *Effect of election.* (1) If the provisions of section 1333 are applicable to any taxable year pursuant to an election made by the taxpayer in accordance with the provisions of paragraph (a) of this section, the period of limitations provided in chapter 66 of the Code on the making of assessments and the beginning of distraint or a proceeding in court for collection with respect to (i) the amount to be added to the tax for such taxable year under the provisions of section 1333 and (ii) any deficiency for such taxable year or for any other taxable year to the extent attributable to the basis of the recovered property being determined under the provisions of section 1336(b), shall not expire prior to the expiration of two years following the date of the making of such election. Such amount or such deficiency may be assessed at any time prior to the expiration of such period, notwithstanding any law or rule of law which would otherwise prevent such assessment and collection.

(2) If the provisions of section 1333 are applicable to any taxable year pursuant to an election made by the taxpayer in accordance with the provisions of paragraph (a) of this section, and refund or credit of any overpayment resulting from the application of such provisions to such taxable year is prevented on the date of the making of such election, or within one year from such date, by the operation of any law or rule of law (other than section 7122 relating to compromises), refund or credit of such overpayment may nevertheless be made or allowed, provided claim therefor is filed within one year from such date. Thus, the amount of such overpayment which may be refunded or credited is not subject to the limitations contained in section 6511 or 6512(b).

(3) In the case of any taxable year ending before the date of the making by the taxpayer of an election under section 1335, no interest shall be paid on any overpayment specified in subparagraph (2) of this paragraph for any period before the expiration of six months following the date of the making of such election by the taxpayer,

and no interest shall be assessed or collected with respect to any amount or any deficiency specified in subparagraph (1) of this paragraph for any period before the expiration of six months following the date of the making of such election by the taxpayer.

[T.D. 6500, 25 FR 12047, Nov. 26, 1960]

§ 1.1336–1 Basis of recovered property.

(a) *General rule.* (1) Under section 1336(a), the unadjusted basis of any war loss property which is recovered and the unadjusted basis of any property which is recovered in lieu of or on account of any such war loss property is considered the fair market value of such recovered property upon the date of its recovery with the following adjustments:

(i) If the sum of the recoveries for the day such property is recovered and of all previous recoveries exceeds the aggregate of the allowable deductions for prior taxable years on account of war losses, so that a portion of the recoveries for such day is treated as gain on the involuntary conversion of property, such fair market value of the property is reduced by the total gain, if any, for such day derived from such recovered property as determined under paragraph (b) of § 1.1332–1.

(ii) Such fair market value, as reduced under subdivision (i) of this subparagraph, is increased by the portion, if any, of the recognized gain resulting from the recoveries for such day which is allocable to such recovered property, as determined under paragraph (b) of § 1.1332–1.

In effect, the unadjusted basis of such property is its fair market value upon the date of its recovery, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of paragraph (b) of § 1.1332–1.

(2) If the respective bases of several properties of a taxpayer determined under section 1336(a) are greatly disproportionate to their adjusted bases immediately before their treatment as war loss properties, the taxpayer may apply to the Commissioner for the allocation of the aggregate of the bases of such properties among them in the proportion of their adjusted bases immediately before the destruction or seizure of such properties determined under section 127(a) of the Internal Revenue Code of 1939. The amount so allocated to any such property, in an application approved by the Commissioner, shall be the unadjusted basis of such property in lieu of the amount determined under subparagraph (1) of this paragraph.

(3) The application to the Commissioner shall set forth a list of all the properties of the taxpayer having an unadjusted basis determined under this section, a description of each such property together with a statement as to the amount of its adjusted basis immediately before the destruction or seizure of such property determined under section 127(a) of the Internal Revenue Code of 1939, and a statement as to whether there has been any substantial change in the use or nature of the property chosen for the allocation from its nature or use immediately before the time it was treated as destroyed or seized. Such application will be allowed unless there has been such a substantial change in the nature or use of such property that the allocation of the bases would produce an arbitrary result, or unless the taxpayer has obtained such tax benefits by reason of the basis determined under subparagraph (1) of this paragraph, that it would be inequitable to change his basis. Thus, the allocation will not be allowed if it would give the taxpayer an unadjusted basis with respect to any property which is less than the amount of the adjustments in reduction of the basis of such property which are allowable after its recovery. For example, when property A is recovered it has an unadjusted basis of $100. After $70 depreciation has been allowed on A, an allocation is sought which would give A an unadjusted basis of $60. Since this is less than the depreciation which is an adjustment against such basis, the allocation will not be permitted.

(4) The amount of any adjustments to the unadjusted basis determined under subparagraph (1) of this paragraph shall, upon the allocation of the bases, be taken as an adjustment to the allocated unadjusted basis. Thus, if $30 depreciation was allowed upon a $100 basis determined under subparagraph (1) of this paragraph and if the

unadjusted basis upon allocation is $75, such $30 depreciation is allowed against such allocated unadjusted basis, so that the adjusted basis of the property is then $45.

(5) The taxpayer may choose any group of recovered properties for allocation, except that if any such recovered properties form one economic unit, such properties may not be separated but all or none must be included in the group. For example, a building may not be separated from the land on which it stands if both are recovered property, nor may one block of stock in a corporation be separated from other stock in such corporation or from bonds in such corporation which are also treated as a recovery. If the taxpayer has once been permitted to allocate the bases of any group of properties, he may obtain another allocation with respect to such properties only if all the properties in the original group are included together with other recovered properties not included in the original group. For example, if the bases of properties A and B are allocated, a second allocation will be made for properties A, B, and C, but not for A and C or B and C.

(b) *Property recovered in taxable year to which section 1333 is applicable.* If, pursuant to an election made by the taxpayer under section 1335 and paragraph (a) of § 1.1335–1, the provisions of section 1333 are applicable to any taxable year in which the taxpayer recovered property in respect of a war loss under section 127(a) of the Internal Revenue Code of 1939, the unadjusted basis of such property shall be the fair market value of such property determined as of the date of the recovery, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of paragraph (b) of § 1.1333–1. However, if the property recovered is the same war loss property, and if the taxpayer under section 1333(1) includes such property in the amount of the recovery at its adjusted basis (for determining loss) in his hands on the date such property was considered under section 127(a) of the Internal Revenue Code of 1939 as destroyed or seized, the unadjusted basis of such property shall be such adjusted basis, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of paragraph (b) of § 1.1333–1. The fair market value of any property recovered, or the adjusted basis for determining loss) of such property if the same property treated as war loss property is recovered, shall not be reduced in determining the unadjusted basis of such property by the amount of the obligations or liabilities with respect to such property in respect of which the recovery was received, if the taxpayer for any previous taxable year chose under section 127(b)(2) of the Internal Revenue Code of 1939 to treat such obligations or liabilities as discharged or satisfied out of such property but such obligations or liabilities were not so discharged or satisfied prior to the date of the recovery.

[T.D. 6500, 25 FR 12048, Nov. 26, 1960]

§ 1.1337–1 Determination of tax benefits from allowable deductions.

(a) That part of the aggregate of the deductions allowed a taxpayer for any taxable year on account of war losses under section 127(a) of the Internal Revenue Code of 1939 which, if disallowed, would not result in an increase in the normal tax, surtax (including the tax imposed by section 102 of the Internal Revenue Code of 1939), or victory tax of taxpayer, or of any tax imposed in lieu of such taxes or of any tax imposed by chapter 2 of the Internal Revenue Code of 1939, for the taxable year in which such deductions are allowed or in any other taxable year, such as a taxable year in which the taxpayer's income tax is computed by reference to a carryover or carryback of net operating losses from the taxable year in which such deductions are allowed, is considered, for the purposes of section 127(a) of the Internal Revenue Code of 1939 an allowable deduction for the taxable year which did not result in a reduction of any tax of the taxpayer under chapter 1 or 2 of the Internal Revenue Code of 1939. In the case of recoveries of war losses and other items to which the recovery exclusion provisions of section 111 apply, such as bad debts, the determination of the tax benefit should be made in accordance with section 111(b) and the regulations thereunder. The deductions

allowed a taxpayer for any taxable year on account of war losses are all the deductions on account of war losses which were claimed by the taxpayer in a return, in a claim for credit or refund of an overpayment, or in a petition to The Tax Court of the United States with respect to such taxable year and which were not disallowed, and all deductions on account of war losses which, although not so claimed by the taxpayer, were nevertheless allowed (for example, by the Commissioner, a court, or The Tax Court) in computing a tax of the taxpayer.

(b) Any deduction allowable for a taxable year on account of a war loss under section 127(a) of the Internal Revenue Code of 1939 which was not claimed by the taxpayer for such year in a return, a claim for credit or refund of an overpayment, or a petition to the Tax Court of the United States and was not allowed as a deduction (for example, by the Commissioner, a court, or the Tax Court) in computing his tax for such year or for any other year is considered a deduction which did not result in a reduction of any tax of the taxpayer under chapter 1 or 2 of the Internal Revenue Code of 1939, since it is an allowable deduction which was not allowed in computing any tax of the taxpayer. If the taxpayer claimed for any taxable year a deduction on account of a war loss, and if such deduction was disallowed, the taxpayer may not subsequently contend for the purposes of section 1331 that such deduction was an allowable deduction for such taxable year.

(c) If the taxpayer elected under section 127(b) of the Internal Revenue Code of 1939 to decrease the amount of a war loss by treating the obligations and liabilities described in that section as discharged or satisfied out of the property destroyed or seized, and if the taxpayer establishes that any of the obligations and liabilities were not so discharged or satisfied, then the amount by which such continuing obligations and liabilities decreased the war loss shall be considered an allowable deduction for the taxable year in which the war loss was sustained which did not result in a reduction of any tax of the taxpayer under chapter 1 or 2 of the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 12048, Nov. 26, 1960]

CLAIM OF RIGHT

§ 1.1341–1 Restoration of amounts received or accrued under claim of right.

(a) *In general.* (1) If, during the taxable year, the taxpayer is entitled under other provisions of chapter 1 of the Internal Revenue Code of 1954 to a deduction of more than $3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the tax provided in paragraph (b) of this section.

(2) For the purpose of this section *income included under a claim of right* means an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such item, and *restoration to another* means a restoration resulting because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item (or portion thereof).

(3) For purposes of determining whether the amount of a deduction described in section 1341(a)(2) exceeds $3,000 for the taxable year, there shall be taken into account the aggregate of all such deductions with respect to each item of income (described in section 1341(a)(1)) of the same class.

(b) *Determination of tax.* (1) Under the circumstances described in paragraph (a) of this section, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the lesser of:

(i) The tax for the taxable year computed under section 1341(a)(4), that is, with the deduction taken into account, or

(ii) The tax for the taxable year computed under section 1341(a)(5), that is, without taking such deduction into account, minus the decrease in tax (net of any increase in tax imposed by section 56, relating to the minimum tax

for tax preferences) (under chapter 1 of the Internal Revenue Code of 1954, under chapter 1 (other than subchapter E) and subchapter E of chapter 2 of the Internal Revenue Code of 1939, or under the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable. For the purpose of this subdivision, the amount of the decrease in tax is not limited to the amount of the tax for the taxable year. See paragraph (i) of this section where the decrease in tax for the prior taxable year (or years) exceeds the tax for the taxable year.

(iii) For purposes of computing, under section 1341(a)(4) and subdivision (i) of this subparagraph, the tax for a taxable year beginning after December 31, 1961, if the deduction of the amount of the restoration results in a net operating loss for the taxable year of restoration, such net operating loss shall, pursuant to section 1341(b)(4)(A), be carried back to the same extent and in the same manner as is provided under section 172 (relating to the net operating loss deduction) and the regulations thereunder. If the aggregate decrease in tax for the taxable year (or years) to which such net operating loss is carried back is greater than the excess of:

(*a*) The amount of decrease in tax for a prior taxable year (or years) computed under section 1341(a)(5)(B), over

(*b*) The tax for the taxable year computed under section 1341(a)(5)(A),

The tax imposed for the taxable year under chapter 1 shall be the tax determined under section 1341(a)(4) and subdivision (i) of this subparagraph. If the tax imposed for the taxable year is determined under section 1341(a)(4) and subdivision (i) of this subparagraph, the decrease in tax for the taxable year (or years) to which the net operating loss is carried back shall be an overpayment of tax for the taxable year (or years) to which the net operating loss is carried back and shall be refunded or credited as an overpayment for such taxable year (or years). See section 6511(d)(2), relating to special period of limitation with respect to net operating loss carrybacks.

(2) Except as otherwise provided in section 1341(b)(4)(B) and paragraph (d)(1)(ii) and (4)(ii) of this section, if the taxpayer computes his tax for the taxable year under the provisions of section 1341(a)(5) and subparagraph (1)(ii) of this paragraph, the amount of the restoration shall not be taken into account in computing taxable income or loss for the taxable year, including the computation of any net operating loss carryback or carryover or any capital loss carryover. However, the amount of such restoration shall be taken into account in adjusting earnings and profits for the current taxable year.

(3) If the tax determined under subparagraph (1)(i) of this paragraph is the same as the tax determined under subparagraph (1)(ii) of this paragraph, the tax imposed for the taxable year under chapter 1 shall be the tax determined under subparagraph (1)(i) of this paragraph, and section 1341 and this section shall not otherwise apply.

(4) After it has been determined whether the tax imposed for a taxable year of restoration beginning after December 31, 1961, shall be computed under the provisions of section 1341(a)(4) or under the provisions of section 1341(a)(5), the net operating loss, if any, which remains after the application of section 1341(b)(4)(A) or the net operating loss or capital loss, if any, which remains after the application of section 1341(b)(4)(B) shall be taken into account in accordance with the following rules:

(i) If it is determined that section 1341(a)(4) and subparagraph (1)(i) of this paragraph apply, then that portion, if any, of the net operating loss for the taxable year which remains after the application of section 1341(b)(4)(A) and subparagraph (1)(iii) of this paragraph shall be taken into account under section 172 for taxable years subsequent to the taxable year of restoration to the same extent and in the same manner as a net operating loss sustained in such taxable year of restoration. Thus, if the net operating loss for the taxable year of restoration (computed with the deduction referred to in section 1341(a)(4)) exceeds the taxable income

(computed with the modifications prescribed in section 172) for the taxable year (or years) to which it is carried back, such excess shall be available as a carryover to taxable years subsequent to the taxable year of restoration.

(ii) If it is determined that section 1341(a)(5) and subparagraph (1)(ii) of this paragraph apply, then that portion, if any, of a net operating loss or capital loss which remains after the application of section 1341(b)(4)(B) and paragraph (d)(4) of this section shall be taken into account under section 172 or 1212, as the case may be, for taxable years subsequent to the taxable year of restoration to the same extent and in the same manner as a net operating loss or capital loss sustained in the prior taxable year (or years). For example, if the net operating loss for the prior taxable year (computed with the exclusion referred to in section 1341(a)(5)(B)) exceeds the taxable income (computed with the modifications prescribed in section 172) for prior taxable years to which such net operating loss is carried back or carried over (including for this purpose the taxable year of restoration), such excess shall be available as a carryover to taxable years subsequent to the taxable year of restoration in accordance with the rules prescribed in section 172 which are applicable to such prior taxable year (or years).

(c) *Application to deductions which are capital in nature.* Section 1341 and this section shall also apply to a deduction which is capital in nature otherwise allowable in the taxable year. If the deduction otherwise allowable is capital in nature, the determination of whether the taxpayer is entitled to the benefits of section 1341 and this section shall be made without regard to the net capital loss limitation imposed by section 1211. For example, if a taxpayer restores $4,000 in the taxable year and such amount is a long-term capital loss, the taxpayer will, nevertheless, be considered to have met the $3,000 deduction requirement for purposes of applying this section, although the full amount of the loss might not be allowable as a deduction for the taxable year. However, if the tax for the taxable year is computed with the deduction taken into account, the deduction allowable will be subject to the limitation on capital losses provided in section 1211, and the capital loss carryover provided in section 1212.

(d) *Determination of decrease in tax for prior taxable years*—(1) *Prior taxable years.* (i) Except as otherwise provided in subdivision (ii) of this subparagraph, the prior taxable year (or years) referred to in paragraph (b) of this section is the year (or years) in which the item to which the deduction is attributable was included in gross income under a claim of right and, in addition, any other prior taxable year (or years) the tax for which will be affected by the exclusion from gross income in such prior taxable year (or years) of such income.

(ii) For purposes of applying section 1341(b)(4)(B) in computing the amount of the decrease referred to in paragraph (b)(1)(ii) of this section for any taxable year beginning after December 31, 1961, the term *prior taxable year (or years)* includes the taxable year of restoration. Under section 1341(b)(4)(B), for taxable years of restoration beginning after December 31, 1961, in any case where the exclusion referred to in section 1341(a)(5)(B) and paragraph (b)(1)(ii) of this section results in a net operating loss or capital loss for the prior taxable year (or years), such loss shall, for purposes of computing the decrease in tax for the prior taxable year (or years) under such section 1341(a)(5)(B) and such paragraph (b)(1)(ii) of this section, be carried back and carried over to the same extent and in the same manner as is provided under section 172 (relating to the net operating loss deduction) or section 1212 (relating to capital loss carryover), except that no carryover beyond the taxable year shall be taken into account. See subparagraph (4) of this paragraph for rules relating to the computation of the amount of decrease in tax.

(2) *Amount of exclusion from gross income in prior taxable years.* (i) The amount to be excluded from gross income for the prior taxable year (or years) in determining the decrease in tax under section 1341(a)(5)(B) and paragraph (b)(1)(ii) of this section shall be the amount restored in the taxable year, but shall not exceed the amount

included in gross income in the prior taxable year (or years) under the claim of right to which the deduction for the restoration is attributable, and shall be adjusted as provided in subdivision (ii) of this subparagraph.

(ii) If the amount included in gross income for the prior taxable year (or years) under the claim of right in question was reduced in such year (or years) by a deduction allowed under section 1202 (or section 117 (b) of the Internal Revenue Code of 1939 or corresponding provisions of prior revenue laws), then the amount determined under subdivision (i) of this subparagraph to be excluded from gross income for such year (or years) shall be reduced in the same proportion that the amount included in gross income under a claim of right was reduced.

(iii) The determination of the amount of the exclusion from gross income of the prior taxable year shall be made without regard to the capital loss limitation contained in section 1211 applicable in computing taxable income for the current taxable year. The amount of the exclusion from gross income in a prior taxable year (or years) shall not exceed the amount which would, but for the application of section 1211, be allowable as a deduction in the taxable year of restoration.

(iv) The rule provided in subdivision (iii) of this subparagraph may be illustrated as follows:

Example: For the taxable year 1952, an individual taxpayer had long-term capital gains of $50,000 and long-term capital losses of $10,000, a net long-term gain of $40,000. He also had other income of $5,000. In 1956, taxpayer restored the $50,000 of long-term gain. He had no capital gains or losses in 1956 but had other income of $5,000. If his tax liability for 1956, the taxable year of restoration, is computed by taking the deduction into account, the taxpayer would be entitled to a deduction under section 1211 of only $1,000 on account of the capital loss. However, if the taxpayer computes his tax under section 1341(a)(5) and paragraph (b)(1)(ii) of this section, it is necessary to determine the decrease in tax for 1952. In such a determination, $50,000 is to be excluded from gross income for that year, resulting in a net capital loss for that year of $10,000, and a capital loss deduction of $1,000 under section 117(d) of the Internal Revenue Code of 1939 (corresponding to section 1211 of the Internal Revenue Code of 1954) with carryover privileges. The difference between the tax previously determined and the tax as recomputed after such exclusion for the years affected will be the amount of the decrease.

(3) *Determination of amount of deduction attributable to prior taxable years.* (i) If the deduction otherwise allowable for the taxable year relates to income included in gross income under a claim of right in more than one prior taxable year and the amount attributable to each such prior taxable year cannot be readily identified, then the portion attributable to each such prior taxable year shall be that proportion of the deduction otherwise allowable for the taxable year which the amount of the income included under the claim of right in question for the prior taxable year bears to the total of all such income included under the claim of right for all such prior taxable years.

(ii) The rule provided in subdivision (i) of this subparagraph may be illustrated as follows:

Example: Under a claim of right, A included in his gross income over a period of three taxable years an aggregate of $9,000 for services to a certain employer, in amounts as follows: $2,000 for taxable year 1952, $4,000 for taxable year 1953, and $3,000 for taxable year 1954. In 1955 it is established that A must restore $6,750 of these amounts to his employer, and that A is entitled to a deduction of this amount in the taxable year 1955. The amount of the deduction attributable to each of the prior taxable years cannot be identified. Accordingly, the amount of the deduction attributable to each prior taxable year is:

1952—$6,750 × $2,000 ÷ $9,000 = $1,500
1953—$6,750 × $4,000 ÷ $9,000 = $3,000
1954—$6,750 × $3,000 ÷ $9,000 = $2,250

(4) *Computation of amount of decrease in tax.* (i) In computing the amount of decrease in tax for a prior taxable year (or years) resulting from the exclusion from gross income of the income included under a claim of right, there must first be ascertained the amount of tax previously determined for the taxpayer for such prior taxable year (or years). The tax previously determined shall be the sum of the amounts shown by the taxpayer on his return or returns, plus any amounts which have been previously assessed (or collected without assessment) as deficiencies or which appropriately should be assessed or collected, reduced by the amount of

any refunds or credits which have previously been made or which appropriately should be made. For taxable years beginning after December 31, 1961, if the provisions of section 1341(b)(4)(B) are applicable, the tax previously determined shall include the tax for the taxable year of restoration computed without taking the deduction for the amount of the restoration into account. After the tax previously determined has been ascertained, a recomputation must then be made to determine the decrease in tax, if any, resulting from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction otherwise allowable in the taxable year is attributable.

(ii) No item other than the exclusion of the income previously included under a claim of right shall be considered in computing the amount of decrease in tax if reconsideration of such other item is prevented by the operation of any provision of the internal revenue laws or any other rule of law. However, if the amounts of other items in the return are dependent upon the amount of adjusted gross income, taxable income, or net income (such as charitable contributions, foreign tax credit, deductions for depletion, and net operating loss), appropriate adjustment shall be made as part of the computation of the decrease in tax. For the purpose of determining the decrease in tax for the prior taxable year (or years) which would result from the exclusion from gross income of the item included under a claim of right, the exclusion of such item shall be given effect not only in the prior taxable year in which it was included in gross income but in all other prior taxable years (including the taxable year of restoration if such year begins after December 31, 1961, and section 1341(b)(4)(B) applies, see subparagraph (1)(ii) of this paragraph) affected by the inclusion of the item (for example, prior taxable years affected by a net operating loss carryback or carryover or capital loss carryover).

(iii) The rules provided in this subparagraph may be illustrated as follows:

Example 1. For the taxable year 1954, a corporation had taxable income of $35,000, on which it paid a tax of $12,700. Included in gross income for the year was $20,000 received under a claim of right as royalties. In 1957, the corporation is required to return $10,000 of the royalties. It otherwise has taxable income in 1957 of $5,000, so that without the application of section 1341 it has a net operating loss of $5,000 in that year. Facts also come to light in 1957 which entitle the corporation to an additional deduction of $5,000 for 1954. When a computation is made under paragraph (b)(1)(i) of this section, the corporation has no tax for the taxable year 1957. When a computation is made under paragraph (b)(1)(ii) of this section, the tax for 1957, without taking the restoration into account, is $1,500, based on a taxable income of $5,000. The decrease in tax for 1954 is computed as follows:

Tax shown on return for 1954		$12,700
Taxable income for 1954 upon which tax shown on return was based		35,000
Less: Additional deduction (on account of which credit or refund could be made)		5,000
Total		30,000
Tax on $30,000 (adjusted taxable income for 1954)		10,100
Tax on $30,000 (adjusted taxable income for 1954)		10,100
Taxable income for 1954, as adjusted	$30,000	
Less exclusion of amount restored	10,000	
Taxable income for 1954 by applying paragraph (b)(1)(ii) of this section	20,000	
Tax on $20,000		6,000
Decrease in tax for 1954 by applying paragraph (b)(1)(ii) of this section		$4,100
Tax for 1957 without taking the restoration into account		1,500
Amount by which decrease exceeds the tax for 1957 computed without taking restoration into account		$2,600

(The $2,600 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1957 and is available as a refund. In addition the taxpayer has made an overpayment of $2,600 ($12,700 less $10,000) for 1954 because of the additional deduction of $5,000.)

Example 2. Assume the same facts as in example (1) except that, instead of the corporation being entitled to an additional deduction of $5,000 for 1954, it is determined that the corporation failed to include an item of $5,000 in gross income for that year. The decrease in tax for 1954 is computed as follows:

Tax shown on return for 1954	$12,700
Taxable income for 1954 upon which tax shown on return was based	35,000
Plus: Additional income (on account of which deficiency assessment could be made)	$5,000
Total	40,000

Tax on $40,000 (adjusted taxable income for 1954)		15,300

Tax on $40,000 (adjusted taxable income for 1954)		15,300
Taxable income for 1954 as adjusted	$40,000	
Less exclusion of amount restored	10,000	
Taxable income for 1954 by applying paragraph (b)(1)(ii) of this section	30,000	
Tax on $30,000		10,100
Decrease in tax for 1954 by applying paragraph (b)(1)(ii) of this section		5,200
Tax for 1957 without taking the restoration into account		1,500
Amount by which decrease exceeds the tax for 1957 computed without taking the restoration into account		$3,700

(The $3,700 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1957 and is available as a refund. In addition the taxpayer has a deficiency of $2,600 ($15,300 less $12,700) for 1954 because of the additional income of $5,000.)

Example 3. For the taxable year 1954, a corporation had taxable income of $25,000, on which it paid a tax of $7,500. Included in gross income for the year was $10,000 received under a claim of right as commissions. In 1956, the corporation is required to return $5,000 of the commissions. The corporation has a net operating loss of $10,000 for 1956, excluding the deduction for the $5,000 restored. When a computation is made under either paragraph (b)(1)(i) or paragraph (b)(1)(ii) of this section, the corporation has no tax for the taxable year 1956. The decrease in tax for 1954 is computed as follows:

Tax shown on return for 1954		$7,500

Taxable income for 1954 upon which tax shown on return was based		25,000
Less: Additional deduction (on account of net operating loss carryback from 1956)		10,000
Net income as adjusted		15,000
Tax on $15,000 (adjusted taxable income for 1954)		4,500

Tax on $15,000 (adjusted taxable income for 1954)		4,500
Taxable income for 1954, as adjusted	$15,000	
Less: exclusion of amount restored	$5,000	
Taxable income for 1954 by applying paragraph (b)(1)(ii) of this section	10,000	
Tax on $10,000		$3,000
Decrease in tax for 1954 by applying paragraph (b)(1)(ii) of this section		1,500
Tax for 1956 without taking the restoration into account		None
Amount by which decrease exceeds the tax for 1956 computed without taking the restoration into account		$1,500

(The $1,500 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1956 and is available as a refund. In addition, the taxpayer has an overpayment of $3,000 ($7,500 less $4,500) for 1954 because of the net operating loss deduction of $10,000.)

Example 4. For the taxable year 1946 a married man with no dependents, who kept his books on the cash receipts and disbursements basis, filed a return (claiming two exemptions) disclosing adjusted gross income of $42,000, deductions amounting to $12,000, and a net income of $30,000. Gross income included among other items, salary in the amount of $15,000 and rental income in the amount of $5,000. During the taxable year he donated $10,000 to the American Red Cross and in his return claimed a deduction of $6,300 on account thereof, representing the maximum deduction allowable under the 15-percent limitation imposed by section 23(o) of the Internal Revenue Code of 1939 for the year 1946. In computing his net income he omitted interest income amounting to $6,000 and neglected to take a deduction for interest paid in the amount of $4,500. The return disclosed a tax liability of $11,970, which was assessed and paid. In 1955, after the expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1946, the taxpayer had to restore the $5,000 included in his gross income in 1946 as rental income. The amount of the decrease in tax for 1946 is $2,467.62, computed as follows:

Tax previously determined for 1946	$11,970.00
Net income for 1946 upon which tax previously determined was based	30,000.00
Less: Rents included under claim of right	5,000.00
Balance	25,000.00
Adjustment for contributions (add 15 percent of $5,000)	750.00
Net income as adjusted	25,750.00
Tax on $25,750	9,502.38
Amount of decrease in tax for 1946:	
Tax previously determined	$11,970.00
Tax as recomputed	9,502.38
Decrease in tax	$2,467.62

The recomputation to determine the amount of the decrease in tax for 1946 does not take into consideration the barred item of $6,000 representing interest received, which was omitted from gross income, or the barred item of $4,500 representing interest paid for which no deduction was allowed. See subdivision (ii) of this subparagraph.

Example 5. (a) *Facts*. For the taxable year 1959, a corporation reporting income on the calendar year basis had taxable income of $20,000 on which it paid a tax of $6,000. Included in gross income for such year was $100,000 received under a claim of right as

royalties. For each of its taxable years 1956, 1957, 1958, 1960, 1961, and 1962, the corporation had taxable income of $10,000 on which it paid tax of $3,000 for each year. In 1963, the corporation returns the entire amount of $100,000 of the royalties. In such taxable year the corporation has taxable income of $25,000 (without taking the deduction of $100,000 into account), and has a net operating loss of $75,000 (taking the deduction of $100,000 into account). In determining whether section 1341(a)(4) or section 1341(a)(5) applies, the corporation will compute the lesser amount of tax referred to in section 1341(a) by applying the rules provided in section 1341(b)(4).

(b) *Tax under section 1341 (a)(4) and (b)(4)(A).* The net operating loss of $75,000 for 1963 (taking into account the deduction of $100,000) is carried back to the three taxable years (1960, 1961, and 1962) in the manner provided under section 172. For purposes of this example it is assumed that no modifications under section 172 are necessary. Since the aggregate taxable income for such three taxable years is only $30,000 the entire taxable income for such years is eliminated by the carryback, and the corporation would be entitled to a refund of the tax for such years in the aggregate amount of $9,000. (In addition, the remaining $45,000 of the net operating loss for 1963 would be available as a carryover to taxable years after the taxable year (1963) to the extent and in the manner provided by section 172.)

(c) *Tax under section 1341 (a)(5) and (b)(4)(B).* The tax for the taxable year (1963) on $25,000 of taxable income (computed without the deduction of $100,000) is $7,500. The exclusion of $100,000 from gross income for the taxable year 1959 (the year in which the item was included) results in a net operating loss of $80,000 for such year ($20,000 taxable income minus the $100,000 exclusion, no adjustments under section 172 being necessary), thus decreasing the tax for such year by the entire amount of $6,000 paid. The resulting net operating loss of $80,000 for 1959 is available as a carryback to 1956, 1957, and 1958, and as a carryover to 1960, 1961, 1962, and 1963. For purposes of this example it is assumed that no modifications under section 172 are necessary. Since the aggregate taxable income for such taxable years is $85,000, all except $5,000 of the 1963 taxable income is eliminated by such carryback and carryover. The tax on such remaining $5,000 of taxable income for 1963 is $1,500, thus decreasing the tax determined for such year by $6,000 ($7,500 minus $1,500). Under section 1341 (a)(5) and (b)(4)(B), the decrease in tax for the prior taxable years exceeds the tax for the taxable year of restoration computed without the deduction of the amount of the restoration by $22,500, computed as follows:

Tax for taxable year 1963 (on taxable income of $25,000 without the deduction)			$7,500
Decrease in tax for prior taxable years:			
Due to exclusion (1959)		$6,000	
Due to net operating loss carryback:			
1956	$3,000		
1957	3,000		
1958	3,000		
		9,000	
Due to net operating loss carryover:			
1960	$3,000		
1961	3,000		
1962	3,000		
1963	6,000		
		15,000	
			30,000
Excess of the decrease in tax for the prior taxable years over the tax for taxable year 1963 ($30,000 less $7,500 tax for the taxable year)			22,500

(d) *Application of section 1341(a)(4) or section 1341(a)(5).* Since the computation under section 1341 (a)(4) and (b)(4)(A) results in an available refund of only $9,000 tax for the taxable years to which the net operating loss for 1963 is carried back, and since the computation under section 1341 (a)(5) and (b)(4)(B) results in an overpayment of $22,500, it is determined that section 1341(a)(5) applies. Accordingly, the $22,500 is treated as having been paid on the last day prescribed by law for the payment of tax for 1963 and is available as a refund.

(e) *Method of accounting.* The provisions of section 1341 and this section shall be applicable in the case of a taxpayer on the cash receipts and disbursements method of accounting only to the taxable year in which the item of income included in a prior year (or years) under a claim of right is actually repaid. However, in the case of a taxpayer on the cash receipts and disbursements method of accounting who constructively received an item of income under a claim of right and included such item of income in gross income in a prior year (or years), the provisions of section 1341 and this section shall be applicable to the taxable year in which the taxpayer is required to relinquish his right to receive such item of income. Such provisions shall be applicable in the case of other taxpayers only to the taxable year which is the proper taxable year (under the method of accounting used by the taxpayer in computing taxable income) for taking into account the deduction resulting

from the restoration of the item of income included in a prior year (or years) under a claim of right. For example, if the taxpayer is on an accrual method of accounting, the provisions of this section shall apply to the year in which the obligation properly accrues for the repayment of the item included under a claim of right.

(f) *Inventory items, stock in trade, and property held primarily for sale in the ordinary course of trade or business.* (1) Except for amounts specified in subparagraphs (2) and (3) of this paragraph, the provisions of section 1341 and this section do not apply to deductions attributable to items which were included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. This section is, therefore, not applicable to sales returns and allowances and similar items.

(2)(i) In the case of taxable years beginning after December 31, 1957, the provisions of section 1341 and this section apply to deductions which arise out of refunds or repayments with respect to rates made by a regulated public utility, as defined in section 7701(a)(33) without regard to the limitation contained in the last two sentences thereof (for taxable years beginning before January 1, 1964, as defined in section 1503(c) (1) or (3) and paragraph (g) of §1.1502–2A (as contained in the 26 CFR edition revised as of April 1, 1996)), if such refunds or repayments are required to be made by the Government, political subdivision, agency, or instrumentality referred to in such section, or are required to be made by an order of a court, or are made in settlement of litigation or under threat or imminence of litigation. Thus, deductions attributable to refunds of charges for the sale of natural gas under rates approved temporarily by a proper governmental authority are, in the case of taxable years beginning after December 31, 1957, eligible for the benefits of section 1341 and this section, if such refunds are required by the governmental authority, or by an order of a court, or are made in settlement of litigation or under threat or imminence of litigation.

(ii) In the case of taxable years beginning before January 1, 1958, the provisions of section 1341 and this section apply to deductions which arise out of refunds or repayments (whether or not with respect to rates) made by a regulated public utility, as defined in section 7701(a)(33) without regard to the limitation contained in the last two sentences thereof (for taxable years beginning before January 1, 1964, as defined in section 1503(c) (1) or (3) and paragraph (g) of §1.1502–2A), if such refunds or repayments are required to be made by the Government, political subdivision, agency, or instrumentality referred to in such section. Thus, in the case of taxable years beginning before January 1, 1958, deductions attributable to refunds or repayments may be eligible for the benefits of section 1341 and this section, even though such refunds or repayments are not with respect to rates. On the other hand, in the case of such taxable years, section 1341 and this section do not apply to any deduction which arises out of a refund or repayment (whether or not with respect to rates) which is required to be made by an order of a court, or which is made in settlement of litigation or under threat or imminence of litigation.

(3) The provisions of section 1341 and this section apply to a deduction which arises out of a payment or repayment made pursuant to a price redetermination provision in a subcontract:

(i) If such subcontract was entered into before January 1, 1958, between persons other than those bearing a relationship set forth in section 267(b);

(ii) If such subcontract is subject to statutory renegotiation; and

(iii) If section 1481 (relating to mitigation of effect of renegotiation of Government contracts) does not apply to such payment or repayment solely because such payment or repayment is not paid or repaid to the United States or any agency thereof.

Thus, a taxpayer who enters into a subcontract to furnish items to a prime contractor with the United States

may, pursuant to a price redetermination provision in the subcontract, be required to refund an amount to the prime contractor or to another subcontractor. Since the refund would be made directly to the prime contractor or to another subcontractor, and not directly to the United States, the taxpayer would be unable to avail himself of the benefits of section 1481. However, the provisions of section 1341 and this section will apply in such a case, if the conditions set forth in subdivisions (i), (ii), and (iii) of this subparagraph are met. For provisions relating to the mitigation of the effect of a redetermination of price with respect to subcontracts entered into after December 31, 1957, when repayment is made to a party other than the United States or any agency thereof, see section 1482.

(g) *Bad debts*. The provisions of sections 1341 and this section do not apply to deductions attributable to bad debts.

(h) *Legal fees and other expenses*. Section 1341 and this section do not apply to legal fees or other expenses incurred by a taxpayer in contesting the restoration of an item previously included in income. This rule may be illustrated by the following example:

Example: A sold his personal residence to B in a prior taxable year and realized a capital gain on the sale. C claimed that under an agreement with A he was entitled to a 5-percent share of the purchase price since he brought the parties together and was instrumental in closing the sale. A rejected C's demand and included the entire amount of the capital gain in gross income for the year of sale. C instituted action and in the taxable year judgment is rendered against A who pays C the amount involved. In addition, A pays legal fees in the taxable year which were incurred in the defense of the action. Section 1341 applies to the payment of the 5-percent share of the purchase price to C. However, the payment of the legal fees, whether or not otherwise deductible, does not constitute an item restored for purposes of section 1341(a) and paragraph (a) of this section.

(i) *Refunds*. If the decrease in tax for the prior taxable year (or years) determined under section 1341(a)(5)(B) and paragraph (b)(1)(ii) of this section exceeds the tax imposed by chapter 1 of the Code for the taxable year computed without the deduction, and for taxable years beginning after December 31, 1961, if such excess is greater than the decrease in tax for the taxable year (or years) to which the net operating loss described in section 1341(b)(4)(A) and paragraph (b)(1)(iii) of this section is carried back, such excess shall be considered to be a payment of tax for the taxable year of restoration. Such payment is deemed to have been made on the last day prescribed by law for the payment of tax for the taxable year and shall be refunded or credited in the same manner as if it were an overpayment of tax for such taxable year. However, no interest shall be allowed or paid if such an excess results from the application of section 1341(a)(5)(B) in the case of a deduction described in paragraph (f)(3) of this section (relating to payments or repayments pursuant to price redetermination). If the tax for the taxable year of restoration is computed under section 1341(a)(4) and results in a decrease in tax for the taxable year (or years) to which a net operating loss described in section 1341(b)(4)(A) is carried back, see paragraph (b)(1)(iii) of this section.

[T.D. 6500, 25 FR 12049, Nov. 26, 1960, as amended by T.D. 6617, 27 FR 10824, Nov. 7, 1962; T.D. 6747, 29 FR 9790, July 21, 1964; T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7564, 43 FR 40496, Sept. 12, 1978; T.D. 8677, 61 FR 33323, June 27, 1996]

§ 1.1342–1 Computation of tax where taxpayer recovers substantial amount held by another under claim of right; effective date.

Section 1342 shall apply with respect to taxable years beginning after December 31, 1954.

[T.D. 6500, 25 FR 12052, Nov. 26, 1960]

OTHER LIMITATIONS

§ 1.1346–1 Recovery of unconstitutional taxes.

(a) *In general*. (1) A taxpayer who recovers unconstitutional Federal taxes which were paid or accrued and for which a deduction was allowed in a prior taxable year may elect, as provided in paragraph (b) of this section, to exclude the income (exclusive of interest) attributable to such recovery from his gross income in the taxable year of recovery. Any such exclusion of

income is subject to the requirements of section 1346 and this section.

(2) If a taxpayer elects to receive the benefits of section 1346, the income (exclusive of interest) attributable to the recovery of the unconstitutional Federal tax will be treated as an offset to the deduction allowed therefor in a prior taxable year (or years). The taxpayer's return for the prior taxable year (or years) with respect to which the statutory period for the assessment of a deficiency has expired will be opened only for the purpose of reducing the deduction allowed for the unconstitutional Federal tax and assessing the resulting deficiency or deficiencies, if any. (An election under section 1346 may be made only if the taxpayer consents in writing to such assessment. See paragraph (b) of this section.) No other adjustment will be allowed.

(3) If the disallowance of the deduction allowed in respect of a prior taxable year results in a deficiency for that year, the deficiency will be assessed against the taxpayer within the period agreed upon between the taxpayer and the district director with respect to the taxable year of the prior deduction, even though the statutory period for the assessment may have expired prior to the filing of the consent.

(4) If a taxpayer does not elect under the provisions of section 1346 and this section to exclude the tax recovered from gross income in the taxable year of recovery, the tax recovered shall, from the standpoint of its inclusion in or exclusion from gross income, be governed by the provisions of section 111.

(b) *Manner of making election.* (1) The election provided for in paragraph (a) of this section shall be made by the taxpayer filing a statement in writing that he elects to treat the deduction allowed in a prior taxable year for the unconstitutional tax as not having been allowable for such taxable year. Such a statement must be filed with the taxpayer's return for the taxable year in which the recovery of the unconstitutional tax or taxes occurs. No other method of making the election is permitted. The statement of election must contain a description of the tax recovered, the date of recovery, the taxable year in which paid or accrued, and the taxable year for which the deduction was allowed. The statement of election must also contain a statement signifying the taxpayer's consent (i) to treat the deduction or portion thereof allowed in a prior year with respect to the unconstitutional tax as not allowable for that year and (ii) to the assessment, in respect of the taxable year for which the deduction was allowed, of any deficiency, together with interest thereon as provided by law, resulting from disallowance of the deduction or portion thereof, even though the statutory period for the assessment of any such deficiency may have expired before the filing of such consent.

(2) The term *recovery*, as used in this section, includes not only refund or credit of taxes previously paid, but also the cancellation of a purported tax liability which was accrued and deducted for a prior taxable year but never actually paid.

[T.D. 6500, 25 FR 12052, Nov. 26, 1960]

§ 1.1347–1 Tax on certain amounts received from the United States.

(a) In the case of an amount (other than interest) received from the United States by an individual under a claim involving acquisition of property and remaining unpaid for more than 15 years, the tax (or, in the case of taxable years beginning before January 1, 1971, the surtax) imposed by section 1 attributable to such amount shall not exceed 33 percent of the amount (other than interest) so received (30 percent for taxable years beginning before January 1, 1971). For the purpose of section 1347 and this section, such amount shall not include any amount received from the United States which constitutes interest, whether such interest was included in the claim or in any judgment thereon or has accrued on such judgment. Section 1347 and this section shall only apply with respect to amounts received under a claim filed with the United States before January 1, 1958.

(b) To determine the application of section 1347 and this section to a particular amount, the taxpayer shall first compute the tax (or, in the case of taxable years beginning before January 1, 1971, the surtax) imposed by section 1 upon his entire taxable income, including the amount specified in paragraph

(a) of this section, without regard to the limitation on tax provided in section 1347. The proportion of the tax (or surtax), so computed, indicated by the ratio which the taxpayer's taxable income attributable to the amount specified in paragraph (a) of this section, computed as prescribed in paragraph (c) of this section, bears to his total taxable income, is the portion of the tax (or surtax) attributable to such amount. If this portion of the tax (or surtax) exceeds 33 percent (30 percent for taxable years beginning before January 1, 1971) of the amount specified in paragraph (a) of this section, that portion of the tax (or surtax) shall be reduced to 33 percent (or 30 percent) of such amount.

(c) In determining the portion of the taxable income attributable to any amount specified in paragraph (a) of this section, the taxpayer shall allocate to such amount received and to the gross income derived from all other sources, the expenses, losses, and other deductions properly attributable thereto, and shall apply any general expenses, losses, and other deductions (which cannot be properly apportioned otherwise) ratably to the gross income from all sources. The amount specified in paragraph (a) of this section, less the deductions properly attributable thereto and less its proportion of any general deductions, shall be the taxable income attributable to such amount. The taxpayer shall submit with his return a statement fully explaining the manner in which such expenses, losses, and deductions are allocated or apportioned.

[T.D. 6500, 25 FR 12052, Nov. 26, 1960, as amended by T.D. 7117, 36 FR 9422, May 25, 1971; 36 FR 11434, June 12, 1971]

§ 1.1348–1 Fifty-percent maximum tax on earned income.

Section 1348 provides generally that for taxable years beginning after December 31, 1971, the maximum tax rate applicable to the earned taxable income of an individual, estate, or trust is not to exceed 50 percent. In the case of an estate or trust, earned income includes only amounts which constitute income in respect of a decedent within § 1.1348–3(a)(4). For taxable years beginning after December 31, 1970, and before January 1, 1972, the maximum rate is 60 percent. Section 1348 does not apply if the taxpayer chooses the benefits of income averaging under sections 1301 through 1305. Section 1348 does not apply to a married individual who does not file a joint return with his spouse for the taxable year. For purposes of section 1348, an individual's marital status shall be determined under section 153 and the regulations thereunder.

[T.D. 7446, 41 FR 55337, Dec. 20, 1976]

§ 1.1348–2 Computation of the fifty-percent maximum tax on earned income.

(a) *Computation of tax for taxable years beginning after 1971.* If, for a taxable year beginning after December 31, 1971, an individual has earned taxable income (as defined in paragraph (d) of this section) which exceeds the applicable amount in column (1) of table A, the tax imposed by section 1 for such year shall be the sum of:

(1) The applicable amount in column (2) of table A.

(2) 50 percent of the amount by which earned taxable income exceeds the applicable amount in column (1) of table A, and

(3) The amount by which the tax imposed by chapter 1 on the entire taxable income exceeds a tax so computed on earned taxable income, such computations to be made without regard to section 1348 or 1301.

TABLE A

Status	(1)	(2)
Married individuals filing joint returns and surviving spouses	$52,000	$18,060
Heads of households	38,000	12,240
Unmarried individuals other than surviving spouses and heads of households	38,000	13,290
Trusts and estates	26,000	9,030

(b) *Computation of tax for taxable years beginning in 1971.* If, for a taxable year beginning after December 31, 1970, and before January 1, 1972, an individual has earned taxable income (as defined in paragraph (d) of this section) which exceeds the applicable amount in column (1) of table B, the tax imposed by section 1 for such year shall be the sum of:

(1) The applicable amount in column (2) of table B,

(2) 60 percent of the amount by which earned taxable income exceeds the applicable amount in column (1) of table B, and

(3) The amount by which the tax imposed by chapter 1 on the entire taxable income exceeds a tax so computed on earned taxable income, such computations to be made without regard to section 1348 or 1301.

TABLE B

Status	(1)	(2)
Married individuals filing joint returns and surviving spouses	$100,000	$45,180
Heads of households	70,000	30,260
Unmarried individuals other than surviving spouses and heads of households	50,000	20,190
Trusts and estates	50,000	22,590

(c) *Short taxable periods.* If a taxpayer is required under section 443(a)(1) to make a return for a period of less than 12 months, the tax under section 1348 and this section shall be determined by placing his taxable income, earned net income, adjusted gross income, and items of tax preference on an annual basis in accordance with section 443 and the regulations thereunder. If a taxable year referred to in paragraph (d)(3)(i)(*a*) of this section is a period of less than 12 months for which a return is required under section 443(a)(1), the average described in such paragraph shall also be determined by placing the items of tax preference for such period on an annual basis in accordance with section 443 and the regulations thereunder. If a return for a period of less than 12 months is required under section 443(a)(3) for any taxable year referred to in paragraph (d)(3)(i)(*a*) of this section, section 1348 and this section shall not apply unless such period is reopened by the taxpayer as provided by section 6851(b).

(d) *Earned taxable income*—(1) *In general.* For purposes of section 1348 and this section, the term *earned taxable income* means the excess of (i) the portion of taxable income which, under subparagraph (2) of this paragraph, is attributable to earned net income over (ii) the tax preference offset (as defined in subparagraph (3) of this paragraph). For purposes of computing the alternative tax under section 1201, earned taxable income shall not exceed the excess of taxable income over 50 percent of the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977).

(2) *Taxable income attributable to earned net income.* The portion of taxable income which is attributable to earned net income shall be determined by multiplying taxable income by a fraction (not exceeding one), the numerator of which is earned net income, and the denominator of which is adjusted gross income. For purposes of this subparagraph the term *earned net income* means the excess of the total of earned income (as defined in §1.1343–(a)) over the total of any deductions which are required to be taken into account under section 62 in determining adjusted gross income and are properly allocable to or chargeable against earned income. Deductions are properly allocable to or chargeable against earned income if, and to the extent that, they are allowable in respect of expenses paid or incurred in connection with the production of earned income and have not been taken into account in determining the net profits of a trade or business in which both personal services and capital are material income producing factors (as defined in §1.1348–3(a)(3)). Except as otherwise provided, deductions properly allocable to or chargeable against earned income include:

(i) Deductions attributable to a trade or business from which earned income is derived, except that if less than all the gross income from a trade or business constitutes earned income, only a ratable portion of the deductions attributable to such trade or business is allowable in respect of expenses paid or incurred in connection with the production of earned income,

(ii) Deductions consisting of expenses paid or incurred in connection with the performance of services as an employee,

(iii) The deductions described in section 62(7) and allowable by sections 404 and 405(c),

(iv) The deduction allowable by section 217,

(v) The deduction allowable by section 1379(b)(3), and

(vi) A net operating loss deduction to the extent that the net operating losses carried to the taxable year are properly allocable to or chargeable against earned income.

A net operating loss carried to the taxable year is properly allocable to or chargeable against earned income in such year to the extent of the excess (if any) of the deductions for the loss year which are properly allocable to or chargeable against earned income and which are allowable under section 172(d) in determining a net operating loss, over the earned income for the loss year. If the excess described in the preceding sentence is less than the entire net operating loss, such excess and the balance of such loss shall be deemed to reduce taxable income ratably for any taxable year to which such loss may be carried. See examples (3) and (4) in subparagraph (4) of this paragraph.

(3) *Tax preference offset*. (i) For purposes of subparagraph (1) of this paragraph, the *tax preference offset* is the amount by which the greater of:

(A) The average of the taxpayer's items of tax preference for the taxable year and the four preceding taxable years, or

(B) The taxpayer's items of tax preference for the taxable year,

exceeds $30,000.

(ii) The items of tax preference to be taken into account under subdivision (i) of this subparagraph for any taxable year shall be those items of tax preference referred to in section 57(a) and the regulations thereunder for the taxable year, but excluding any amount not taken into account in computing the tax under section 56(a) and the regulations thereunder for such taxable year. The items of tax preference to be taken into account by an individual for any taxable year in which such individual is or was a nonresident alien shall not include items of tax preference which are not effectively connected with the conduct of a trade or business within the United States.

(iii) Taxable years ending before January 1, 1970 shall not be included in computing the average described in subdivision (i)(A) of this subparagraph. Thus, for example, the tax preference offset for a taxable year ending on December 31, 1973, is the amount by which the average of the taxpayer's items of tax preference for 1970, 1971, 1972, and 1973, or the taxpayer's items of tax preference for 1973, whichever is greater, exceeds $30,000. Taxable years during which the taxpayer was not in existence shall not be included in computing the average described in subdivision (i)(A) of this subparagraph. A fractional part of a year which is treated as a taxable year under sections 441(b) and 7701(a)(23) shall be treated as a taxable year for purposes of this section for special rules if a taxable year referred to in subdivision (i)(A) of this subparagraph is a period of less than 12 months for which a return is required under section 443(a)(1).

(iv) If for the current taxable year the taxpayer and his spouse (or the estate of such spouse) file a joint return together, the items of tax preference for a preceding taxable year taken into account under subdivision (i)(A) of this subparagraph shall be the sum of the items of tax preference of the taxpayer and his spouse for such preceding year even though a joint return was not, or could not have been, filed by the taxpayer and such spouse for such preceding taxable year. If for the current taxable year the taxpayer (A) is no longer married to a spouse to whom he was married for a preceding taxable year taken into account under subdivision (i)(A) of this subparagraph and files a return as a single person, head of household, or surviving spouse for such current taxable year, or (B) is married to a spouse other than the spouse to whom he was married for a preceding taxable year taken into account under subdivision (i)(A) of this subparagraph, his items of tax preference shall be computed as if he were not married during such preceding taxable year.

(v) The sum of the items of tax preference of an estate or trust shall, for purposes of this paragraph, be apportioned between the estate or trust and the beneficiary in the manner and to the extent provided by section 58(c)(1) and the regulations thereunder.

(vi) If an item of gross income in respect of a decedent is includible in the gross income of a taxpayer and is treated as earned income in the hands

of the taxpayer by reason of § 1.1348–3(a)(4), the items of tax preference for a taxable year taken into account under subdivision (i) of this subparagraph shall be the sum of the taxpayer's items of tax preference for such taxable year and the decedent's items of tax preference for any taxable year of the decedent (including a short taxable year described in section 441(b)(3)) which ends with or within such taxable year of the taxpayer. For purposes of this subdivision, if a taxpayer (such as the estate of the decedent or a testamentary trust created by the decedent) has not been in existence for the number of preceding taxable years specified in subdivision (i)(A) or (iii) of this subparagraph, the items of tax preference for preceding taxable years taken into account shall be the taxpayer's items of tax preference for each of its preceding taxable years plus the decedent's items of tax preference for that number of the most recent taxable years of the decedent ending prior to the taxpayer's earliest taxable year which, when added to the taxpayer's preceding taxable years, equals such number of preceding taxable years specified in subdivision (i)(A), or (iii). The increase, if any, in the taxpayer's tax preference offset computed under this subdivision shall not exceed the amount by which the taxpayer's taxable income attributable to earned net income, computed as provided in § 1.1348–2(d)(2) and including the item of gross income in respect of a decedent, exceeds the taxpayer's taxable income attributable to earned net income computed without regard to such item of gross income.

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

Example 1. (i) H and W, married calendar-year taxpayers filing a joint return, have the following items of income, deductions, and tax preference for 1976:

(a) Salary	$155,000	
(b) Dividends and interest	60,000	
Total	215,000	
(c) Deductible travel expenses of employee allocable to earned income	5,000	
(d) Adjusted gross income		$210,000
(e) Exemptions and itemized deductions		38,000
(f) Taxable income		172,000

In addition, the taxpayers have tax preference items for 1976 of $80,000 attributable to the exercise of a qualified stock option and total tax preference items of $300,000 for the years 1972 through 1975. Since the items of tax preference for 1976 exceed the average of the items of tax preference for the years 1972 through 1976, the tax preference offset for 1976 is $50,000 ($80,000 − $30,000).

(ii) H and W have earned taxable income of $72,857 determined in the following manner:

(a) Earned income		$155,000
(b) Earned net income ($155,000 − $5,000)		150,000
(c) Taxable income		172,000
(d) Adjusted gross income		210,000
(e) Taxable income attributable to earned net income: $172,000(c) × ($150,000(b) / $210,000(d)	$122,857	
(f) Tax preference offset	50,000	
(g) Earned taxable income		72,857

(iii) The tax imposed by section 1 is $90,938, determined pursuant to section 1348 in the following manner:

(a) Applicable amount from col. (2) of table A, § 1.1348–2(a)		$18,060
(b) 50 pct of amount by which $72,857 (earned taxable income) exceeds $52,000 (applicable amount from col. (1) of table A, § 1.1348–2(a))		10,429
(c) Tax computed under section 1 on $172,000 (taxable income)	$91,740	
(d) Tax computed under section 1 on $72,857 (earned taxable income)	29,291	
(e) Item (c) minus item (d)		962,449
(f) Tax (total of items (a), (b), and (e))		90,938

Example 2. (i) H and W, married calendar-year taxpayers filing a joint return, have the following items of income, deductions, and tax preference for 1976:

(a) Salary	$210,000	
(b) Dividends and interest	20,000	
(c) Net long-term capital gains	100,000	
Total	330,000	
(d) Sec. 1202 deduction (½ of net long-term capital gains)	50,000	
(e) Adjusted gross income		$280,000
(f) Exemptions and itemized deductions		40,000
(g) Taxable income		240,000

The taxpayers' tax preference item for 1976 is one-half of the net long-term capital gains of $100,000, or $50,000. The taxpayers have no items of tax preference for the years 1972 through 1975. Accordingly, their tax preference offset for 1976 is $20,000 ($50,000 − $30,000).

(ii) H and W have earned taxable income of $160,000, determined in the following manner:

(a) Earned net income		$210,000
(b) Taxable income		240,000
(c) Adjusted gross income		280,000
(d) Taxable income attributable to earned net income: $240,000(b) × ($210,000(a) / $280,000(c))	180,000	

(e) Tax preference offset	$20,000	
(f) Earned taxable income		$160,000

(iii) The tax imposed by section 1 is $122,560, determined pursuant to section 1348 in the following manner:

(a) Applicable amount from col. (2) of table A, § 1.1348–2(a)		$18,060
(b) 50 pct of amount by which $160,000 (earned taxable income) exceeds $52,000 (applicable amount from col. (1) of table A, § 1.1348–2(a))		54,000
(c) Tax computed under section 1201(b) on $240,000 (taxable income):		
(1) Tax under section 1201(b)(1) (tax under section 1 on $190,000 (taxable income excluding capital gains))	$104,080	
(2) Tax under section 1201(b)(2) (25 pct of subsection (d) gain of $50,000)	12,500	
(3) Tax under section 1201(b)(3) (tax under section 1 on $240,000 (taxable income) less tax under section 1 on $215,000 (amount subject to tax under section 1201(b)(1) plus 50 pct of subsection (d) gain)) ($138,980 − $121,480)	17,500	
Total	134,080	
(d) Tax computed under section 1 on $160,000 (earned taxable income)	83,580	
(e) Item (c) through item (d)		50,500
(f) Tax (total of items (a), (b), and (e))		$122,560

Example 3. (i) A, an unmarried calendar year taxpayer engaged in the practice of law, has the following items of income and deductions for 1973 and 1976:

	1973	1976
Gross income from law practice	$240,000	$100,000
Dividends	60,000	20,000
Expense paid in law practice	50,000	160,000
Investment interest	30,000	10,000
Casualty loss on personal residence (amount in excess of $100)		50,000

(ii) For 1976, A's deductions exceed his gross income, and his taxable income is therefore zero. In addition, A has a net operating loss of $100,000 (i.e., the excess of his deductions of $220,000 over his gross income of $120,000), which may be carried back to 1973. In computing his taxable income and earned taxable income for 1973, $60,000 (i.e., the excess of the expenses paid in A's law practice of $160,000, over his gross income from his law practice of $100,000) of the net operating loss deduction is properly allocable to or chargeable against earned income.

(iii) A's recomputed taxable income and earned taxable income for 1973 are $119,250 and $103,350 respectively, determined in the following manner:

Gross income ($240,000 + $60,000)	$300,000
Adjusted gross income ($300,000 − $50,000 − $100,000)	150,000
Taxable income ($150,000 − $30,000 − $750)	119,250
Earned net income ($240,000 − $50,000 − $60,000)	130,000
Earned taxable income ($130,000 / $150,000 × $119,250)	$103,350

Example 4. The facts are the same as in example (3) except that A's gross income from his law practice for 1973 is $40,000. Thus, for 1973, A's deductions (including the net operating loss deduction) exceed his gross income, and his recomputed taxable income is therefore zero. The taxable income subtracted from the net operating loss to determine the carryback to 1974 is $20,000 (i.e., $40,000 + $60,000 − $50,000 − $30,000), and thus the net operating loss carryback to 1974 is $20,000 (i.e., $40,000 + $60,000 − $50,000 − $30,000), and thus the net operating loss carryback from 1976 to 1974 is $80,000 (i.e., $100,000 − $20,000). Of this amount, $48,000 ($80,000 × [$60,000 (the excess of the expenses paid in 1976 in A's law practice over his gross income from his law practice) ÷ $100,000 (A's net operating loss for 1976)]) is properly allocable to or chargeable against earned income, and must be taken into account in recomputing A's taxable income and earned taxable income for 1974.

Example 5. A, an unmarried calendar year taxpayer, receives a salary of $80,000 from Corporation X in 1975 and also owns and operates a laundry in which both his capital and services are material income producing factors. A incurs no section 62 expenses with respect to the salary income. In 1975 the laundry, a sole proprietorship, has gross income of $100,000 and business expenses deductible under section 62 of $80,000. A reasonable allowance as compensation for A's personal services rendered by him in his laundry business would be $12,000. The net profits of the laundry business were $20,000.

A's earned income from the laundry business is limited to $6,000 (30 percent of $20,000). A's total earned income is $36,000 ($80,000 + $60,000). Since the section 62 deductions of the laundry business have already been taken into account in computing net profits, they are not again taken into account in computing earned net income. Accordingly, A's earned net income for 1975 is $86,000.

Example 6. The facts are the same as example (5) except that the gross income of the laundry is $130,000 and the net profits from the laundry are $50,000. A's earned income from the laundry is $12,000. Even though the 30-percent-of-net profits limitation has not resulted in a reduction of A's earned income from the laundry, the expenses deducted in computing net profits do not reduce earned income. Accordingly, both the earned income and the earned net income of A for 1975 are $92,000.

Example 7. The facts are the same as example (5) except that the gross income of the

laundry is $60,000 and the laundry has a net loss of $20,000. A's earned income from the laundry is $12,000. Since the laundry does not have net profits, the expenses of the laundry have not been taken into account in computing the net profits limitation. Accordingly, a ratable portion of deductible expenses of the laundry must be allocated to the earned income from the laundry in accordance with §1.1348–2(d)(2); $16,000 of the expenses are allocated to the earned income ($12,000/$60,000 × $80,000). A's total earned income for 1975 is $92,000, and his earned net income is $76,000 ($92,000 minus $16,000).

[T.D. 7446, 41 FR 55337, Dec. 20, 1976, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1348–3 Definitions.

(a) *Earned income*—(1) *In general.* (i) For purposes of section 1348 and the regulations thereunder, the term *earned income* means any item of gross income which is earned income within the meaning of section 401(c)(2)(C) or 911(b) unless the item constitutes deferred compensation as defined in paragraph (b) of this section or is otherwise excluded by application of this paragraph. Thus, subject to such exceptions, the term includes:

(A) Wages, salaries, professional fees, bonuses, amounts includible in gross income under section 83, commissions on sales or on insurance premiums, tips, and other amounts received, actually or constructively, as compensation for personal services actually rendered regardless of the medium or basis of payment.

(B) Compensatory payments for personal services made prior to the time such services are actually rendered, provided such advance payments are not made for a purpose of minimizing Federal income taxes by reason of the application of section 1348, and are either customary in the particular profession, trade, or business, or are made for a bona fide business purpose.

(C) Prizes and awards in recognition of personal services includible in gross income under section 74, amounts includible in gross income under section 79 (relating to group-term life insurance purchased for employees), and amounts includible in gross income under section 1379(b) (relating to contributions to qualified pension plans in the case of certain shareholder-employees); and

(D) Gains (other than gain which is treated as capital gain under any provision of chapter 1) and net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property (other than good will) by an individual whose personal efforts created such property

The term does not include such income as dividends (including an amount treated as a dividend by reason of section 1373(b) and §1.1373–1), other distributions of corporate earnings and profits, gambling gains, or gains which are treated as capital gains under any provision of chapter 1. The term also does not include amounts received for refraining from rendering personal services or engaging in competitive activity or amounts received as consideration for the cancellation of an employment contract.

(ii) In the case of a nonresident alien individual, earned income includes only earned income from sources within the United States which is effectively connected with the conduct of a trade or business within the United States.

(2) *Earned income and employed assistants.* The entire amount received as professional fees shall be treated as earned income if the taxpayer is engaged in a professional occupation, such as a doctor, dentist, lawyer, architect, or accountant, even though he employs assistants to perform part or all of the services, provided the patients or clients are those of the taxpayer and look to the taxpayer as the person responsible for the services performed.

(3) *Earned income from business in which capital is material.* (i) If an individual is engaged in a trade or business (other than in corporate form) in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered by the individual shall be considered earned income, but the total amount which shall be treated as the earned income of the individual from such a trade or business shall in no case exceed 30 percent of his share of the net profits of such trade or business (which share shall include any

guaranteed payment (as defined by §1.707–1(c)) received from a partnership). For purpose of the preceding sentence, the term *net profits of the trade or business* means the excess of gross income from such trade or business (including income from all sources, whether or not subject to Federal income tax, and without taking into account any deductions which may be allowable under section 1202) over the deductions attributable to such trade or business.

(ii) Whether capital is a material income-producing factor must be determined by reference to all the facts of each case. Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business, as reflected, for example, by a substantial investment in inventories, plant, machinery, or other equipment. In general, capital is not a material income-producing factor where gross income of the business consists principally of fees, commissions, or other compensation for personal services performed by an individual. Thus, the practice of his profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which he conducts his practice since his capital investment is regarded as only incidental to his professional practice.

(iii) This subparagraph does not apply to gains and net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property by an individual whose personal efforts created such property which are, by reason of subparagraph (1)(i) of this paragraph, treated as earned income. Thus, for example, a research chemist's substantial capital investment in laboratory facilities which he uses to produce patentable chemical processes from which he derives gains within the meaning of this subdivision would not be considered a material income-producing factor.

(4) *Income in respect of a decedent.* An item of gross income in respect of a decedent includible in the gross income of a person described in section described in section 691(a)(1) shall be treated as earned income in the hands of such person for purposes of subparagraph (1) of this paragraph if such item of gross income would have constituted earned income of the decedent had he lived and received such amount. See §1.1348–2(d)(3)(vi) for rules relating to attribution of tax preferences by reason of an item of income in respect of a decedent.

(5) *Exceptions to definition of earned income.* For purposes of section 1348 and the regulations thereunder, the term *earned income* does not include:

(i) Any distribution to which section 72(m)(5), relating to certain amounts received by owner-employees from a trust described in section 401(a) or under a plan described in section 403(a), applies,

(ii) Any distribution to which section 402(e), relating to the treatment of certain total distributions from a trust described in section 401(a) or under a plan described in section 403(a), applies,

(iii) Any distribution to which section 402(a)(2), relating to capital gains treatment of certain total distributions from a trust described in section 401(a), applies,

(iv) Any distribution to which section 403(a)(2)(A), relating to capital gains treatment for certain distributions under a plan described in section 404(a)(2), applies, or

(v) Any deferred compensation within the meaning of paragraph (b) of this section.

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

Example 1. A owns and operates an unincorporated laundering and dry cleaning business. A, assisted by his employees, devotes his entire time and attention to this business. Substantial capital is invested in the plant and equipment utilized in the laundering and dry cleaning of clothing for A's customers. Although personal services performed by A and his employees are a material income-producing factor in A's business, the capital investment in plant and equipment is not merely incidental to the performance of such services but is, as such,

material to the production of business income. Therefore, A's laundering and dry cleaning business is one in which both personal services and capital are material income-producing factors within the meaning of paragraph (a)(3) of this section. A may treat as earned income for a taxable year a reasonable allowance as compensation for the personal services rendered by him in his business, but the amount so treated shall not exceed 30% of the net profits of his business for such year.

Example 2. In his unincorporated business as a real estate broker, which he conducts on a full-time basis, A performs substantial personal services, including solicitation of home buyers and sellers, escorting prospective buyers on house visits, arranging appraisal, financing, and legal services, and other related tasks. In the course of conducting such business, A often finances sales of real estate with his own capital, makes all the necessary arrangements incident to such financing, and a substantial portion of the gross income of the business consists of interest income from such financing. Under these facts and circumstances, both personal services and capital are material income-producing factors in A's real estate business within the meaning of paragraph (a)(3) of this section since the financing of real estate sales is an integral part of the entire business. Accordingly, A's earned income from his real estate business is limited to a reasonable allowance as compensation for the personal services A actually renders, but not in excess of 30% of the net profits from the business, including the interest income derived from financing sales of real estate.

Example 3. For his taxable year ending on December 31, 1973, A, a radiologist, reports fees of $100x for professional services rendered to his own patients during 1973. Since 1970, A has maintained his own office in a small building that he purchased for $60x. In addition, A owns X-ray equipment with an original cost of $300x which he uses in his professional practice. The entire $100x of professional fees earned by A during 1973 is treated as earned income, notwithstanding that A has a substantial capital investment in professional equipment and the office from which he conducts his medical practice, because such capital investment is only incidental to the rendition of personal services in A's professional practice.

(b) *Deferred compensation*—(1) *In general.* For purposes of section 1348 and the regulations thereunder, the term *deferred compensation* means, except as otherwise provided in subparagraph (2) of this paragraph, any compensation which is deferred within the meaning of that concept in section 404, including any deferred compensation to which the provisions of section 404 and the regulations thereunder apply and any other compensation taxation of which is deferred in a manner similar to the treatment applicable to deferred compensation to which such provisions apply. Thus, the term includes any amounts includable in gross income as compensation for personal services pursuant to a plan, or method having the effect of a plan, deferring the taxation of such payment to a taxable year later than that in which such services were rendered. For purposes of section 1348, the term *deferred compensation* is not limited to payments to common-law employees but also includes payments to self-employed individuals: nor is it material that no deduction is allowable in respect of all or part of such payments or that a deduction in respect thereof is allowable under some provision of the Code other than section 404. For example, amounts received by a retired partner pursuant to a written plan of the partnership of the kind described in section 1402(a)(10) constitute deferred compensation except as otherwise provided in subparagraph (2) of this paragraph. The term *deferred compensation*, as defined in this paragraph, shall have no application to a determination of the deductibility of any amount under section 162, 404, or any other provision of the Code.

(2) *Amounts not treated as deferred compensation.* Notwithstanding the provisions of subparagraph (1) of this paragraph, any amount includible in gross income as compensation before the end of the taxable year following the first taxable year of the taxpayer in which his right to receive such amount is not subject to any requirement or condition which would be treated as resulting in a substantial risk of forfeiture within the meaning of section 83 and the regulations thereunder does not constitute deferred compensation for purposes of section 1348 and the regulations thereunder. For purposes of this subparagraph, a fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) shall be treated as a taxable year.

(3) *Application to certain compensation*—(i) *In general.* This subparagraph provides rules for the application of the principles of subparagraphs (1) and (2)

of this paragraph to certain types of compensation.

(ii) *Pension, etc., plans.* (A) In accordance with subparagraph (1) of this paragraph, the taxable portion of distributions under a pension, annuity, profit-sharing, or stock bonus plan, whether or not such plan meets the requirements of section 401(a), or pursuant to a method having the effect of such a plan, generally constitutes deferred compensation. However, under subparagraph (2) of this paragraph, such portion constitutes earned income if includible in gross income before the end of the taxable year following the first taxable year of the taxpayer in which his right to receive such amount is not subject to a substantial risk of forfeiture. In the case of a distribution under a contributory plan, the preceding sentence applies only to that part of the taxable portion of the distribution which is attributable to employer contributions to the plan. For purposes of the preceding sentence, that part of the taxable portion of a distribution which is attributable to employer contributions is the amount of such part, multiplied by a fraction, the numerator of which is the employer contributions to the plan on behalf of the employee (determined in accordance with the principles of §1.402(a)–2), and the denominator of which is the sum of such employer contributions and the net employee contributions to the plan (as defined in paragraph (a)(2) of §1.402(a)–2). Thus, if the employer does not contribute to the plan, no part of any distribution thereunder constitutes earned income. Amounts included in gross income under section 402(b), 403(c), or 1379(b)(1) in respect of employer contributions to a plan described in this subdivision do not constitute deferred compensation.

(B) If a recipient's rights to receive amounts pursuant to a plan cease to be subject to a substantial risk of forfeiture in more than one of his taxable years, each payment pursuant to such plan shall be considered to consist of a ratable portion of all of the amounts which are not subject to a substantial risk of forfeiture at the time of such payment. Thus, for example, if an employment contract provides in part that an employee or his estate is to receive in each of the fifteen years after the year in which he attains or would have attained age 65 an amount equal to $2,000 times his years of service with the employer and if he had eighteen years of service with the employer, each $36,000 payment would be considered to consist of 18 payments of $2,000, his right to receive one of which ceased to be subject to a substantial risk of forfeiture upon completing his first year of service with the employer, his right to receive another of which ceased to be subject to a substantial risk of forfeiture upon completing his second year of service with the employer, etc. Therefore, if the employee's last year of service with the employer was completed in the year in which he attained age 65, $2,000 of the first payment in the next year would not be deferred compensation under subparagraph (2) of this paragraph, and the remaining $34,000 of that payment and all of the other fourteen payments of $36,000 would be deferred compensation. If the employee's last year of service was completed in an earlier year, all fifteen payments would constitute deferred compensation in full.

(iii) *Income attributable to options.* (A) Ordinary income realized by a taxpayer upon a disqualifying disposition of stock acquired pursuant to the exercise of a statutory option (as defined in §1.421–7(b)) is not deferred compensation for purposes of subparagraph (1) of this paragraph and, therefore, constitutes earned income.

(B) Ordinary income realized by a taxpayer upon the transfer of property pursuant to the exercise, or sale or other disposition, of an option which is not a statutory option (as defined in §1.421–7(b)) and which was granted on or before December 15, 1971, is not deferred compensation for purposes of subparagraph (1) of this paragraph and, therefore, constitutes earned income. Ordinary income realized by a taxpayer upon the transfer of property pursuant to the exercise, or sale or other disposition, of an option which is not a statutory option (as defined in §1.421–(b)) and which is granted after December 15, 1971 constitutes earned income rather than deferred compensation if such option cannot, by its terms, be exercised more than three months after

termination (for any reason other than death) of the grantee's employment by the grantor of the option. If the terms of such an option granted after December 15, 1971 permit the exercise of the option more than three months after termination (for any reason other than death) of the grantee's employment by the grantor, ordinary income realized by a taxpayer upon the transfer of property pursuant to exercise, or sale or other disposition, of the option constitutes earned income rather than deferred compensation only if such income is realized in a taxable year no later than that following the taxable year in which the option was granted. In the case of the grantee's death within a period during which ordinary income realized upon the transfer of property pursuant to his exercise, or sale or other disposition, of an option described in this subdivision would have constituted earned income as provided in this subdivision had the grantee lived, ordinary income realized subsequently upon the transfer of property pursuant to exercise, or sale or other disposition, of an option described in this subdivision, by the grantee's legal represedntatives or beneficiary constitutes earned income only if such exercise or sale or other disposition, occurs on a date no later than the date twelve months following that of the grantee's death. For purposes of this subdivision, the term *employment by the grantor* includes employment by a related corporation as defined in §1.421–7(i), and by a corporation which is considered a related corporation under §1.421–7(h)(3). Therefore, the transfer of an employee from the grantor corporation to such a related corporation or from one related corporation to another related corporation or to the grantor corporation will not be treated as a termination of employment by the grantor.

(C) For purposes of (B) of this subdivision, if an option described therein and granted after December 15, 1971 is exercisable only following completion of a specified period of employment, the taxable year in which such period of employment is completed shall be treated as the taxable year in which the option was granted. Further, if the terms of an option described in (B) of this subdivision and granted after December 15, 1971 are modified, such modification shall not be considered as the granting of a new option for purposes of (B) in determining the taxable year in which such option was granted.

(D) For purposes of (B) of this subdivision, an option will not be considered exercisable by its terms more than three months following termination (for any reason other than death) of the grantee's employment by the grantor solely because the terms of such option permit, in the event of such grantee's death within three months following termination of such employment, exercise of the option by the grantee's legal representative or beneficiary during or following such three-month period.

(4) *Examples*. The application of this paragraph may be illustrated by the following examples, in each of which it is assumed that any amounts paid as described therein constitute salaries or other compensation for personal services actually rendered rather than a distribution of earnings and profits:

Example 1. (i) On January 1, 1965, Corporation X and E, an individual, execute an employment contract under which E is to be employed by X for a period of 10 years. Under the contract, E is entitled to a stated annual salary and to additional compensation of $10x for each year. This additional compensation is to be credited as of December 31 of each year to a bookkeeping reserve account and will be deferred, accumulated, and paid only upon termination of the employment contract, E's becoming a part-time employee of X, or E's becoming partially or totally incapacitated. Under the terms of the contract, X is merely under a contractual obligation to make the payments when due, and neither X nor E intends that the amounts in the reserve be held by X in trust for E. The contract provides that if E shall fall or refuse to perform his duties, X will be relieved of any obligation to make further credits to the reserve but not of the obligation to distribute amounts previously credited to the reserve. In the event E should die prior to his receipt in full of the balance in the account, the remaining balance is distributed to his personal representative.

(ii) Having completed the terms of his employment contract, E retires from the employment of X on December 31, 1974, and on January 15, 1975, receives a total distribution of $100x from his reserve account. Of this distribution of $100x to E, only $10x, representing the credit made to E's reserve account in 1974, constitutes earned income. No

other credits to E's reserve account are taken into account for this purpose because they were made to the reserve account and became nonforfeitable in a year earlier than the year preceding that in which the $100x distribution was made to E.

Example 2. (i) Corporation X follows a policy of permitting employees to elect before the beginning of any calendar year to defer the receipt of either 5 percent or 10 percent of their stated annual salary to be earned in that year. E, an employee, elects for each of 10 years of employment to defer receipt of $5x of his stated annual salary. The total so deferred, or $50x, is paid to E on January 15, 1974.

(ii) Since the salary which E elects to defer is includible in his gross income only in the taxable year in which actually received by him, then to the extent E receives any such deferred salary payment after the end of the taxable year following the taxable year from which such payment was deferred, such payment does not constitute earned income since such payment is deferred compensation under this paragraph (b). Accordingly, of the $50x distribution to E, only $5x, representing the salary deferral from 1973, constitutes earned income.

Example 3. (i) E is an officer of Corporation X, which has a plan for making future payments of additional compensation for current services to certain employees. The plan provides that a fixed percentage of the annual net earnings in excess of $400x is to be designated for division among the participants. This amount is not currently paid to the participants; but X has set up on its books a separate account for each participant, including E, and each year it credits thereto the dollar amount of his participation for the year. Distributions are to be made from the account when the employee reaches the age of 60, is no longer employed by X, including cessation of employment due to death, or becomes totally unable to perform his duties, whichever occurs first. X's liability to make these distributions is contingent upon the employee's refraining from engaging in any business competitive to that of X, making himself available to X for consultation and advice after retirement or termination of his services, unless disabled, and retaining unencumbered any interest or benefit under the plan. In the event of his death, either before or after the beginning of payments, amounts in an employee's account are distributable to his designated beneficiaries of heirs-at-law. Under the facts and circumstances, E's rights to distributions from his account pursuant to the terms of the plan are not subject to a substantial risk of forfeiture within the meaning of section 83(c)(1). Under the terms of the compensation plan, X is under a merely contractual obligation to make the payments when due, and the parties did not intend that the amounts in each account be held by X in trust for the participants.

(ii) Cash or property includable in gross income by E which is attributable to a credit to his account in a taxable year earlier than the year immediately preceding the year on onclusion does not constitute earned income since it is deferred compensation within the meaning of this paragraph (b). See subparagraph (3) of this paragraph (b) for rules for determining that portion of distributions from E's acount which are attributable to credits to his account in a taxable year immediately preceding the year in which such distributions are made.

Example 4. (i) Corporation X has an annual incentive bonus plan for its employees. Under this plan, X has the sole discretion to defer all or any part of any employee's incentive bonus award. In addition, no employee has any right to receive any incentive bonus for any year (whether to be paid currently or to be deferred) until such time, if any, as X makes an award to him. No employee has any election as to the amount or time of payment of his award for any year. Furthermore, the last of any payments under an award must be paid no later than 10 years from the normal retirement date of the employee. In addition, the obligations of X under the plan are merely contractual and are not funded or secured. The awards are nonassignable. However, in the case of death the awards are payable to the employee's designated beneficiary. Once made, a bonus award under the plan is not subject to any substantial risk of forfeiture.

(ii) In each of the years 1967, 1968, 1969, and 1970, X awards E a deferred bonus of $100x. E retires on June 30, 1971. Beginning in 1971, X pays to E the total of $400x of deferred bonus awards in 5 annual installments of $80x each. With respect to the $80x payment made to E in 1971, $20x, representing the ratable portion of the payment ($100x/$400x × $80x) allocable to the 1970 bonus award, is earned income because it was received in a year no later than the year following that (1970) in which E's right to receive such amount was no longer subject to a substantial risk of forfeiture. The balance of the $80x payment made in 1971 and all payments made subsequently constitute deferred compensation.

Example 5. (i) Under the terms of a nonqualified bonus planfor its executive employees, Corporation M contributes each year to a bonus reserve a given percentage of its net earnings for the year. M makes bonus awards each year from the reserve in cash or stock of M, or a combination of both, to such executive employees, and in such amounts, as M may determine. The bonus award so determined to be made to a beneficiary is paid to him in installments: 20 percent of the award at the time that the award is made and the remaining installments in January of each succeeding year (until the full amount of the

award is paid). Such amounts are payable in succeeding years but only if earned out by the employee by continuing service to M, at the rate of 1/12th of the amount of the first installment for each complete month of service beginning with the year of determination. If the beneficiary voluntarily terminates his employment, is discharged for cause, or conducts himself in a manner inimical to the best interests of M, he forfeits the rights to receive any portion of his bonus award previously earned out but undelivered to him and to continue earning out his bonus award. Upon retirement a beneficiary retains the right to earn out an unearned bonus award but forfeits the right to continue earning out the award if he conducts himself in a manner inimical to M's best interests or engages in an activity which is in competition with an activity of M. If a beneficiary dies while earning out a bonus award, any unpaid and undelivered portion of his award is paid and delivered to his estate or heirs at such time and in such manner as if the beneficiary were living.

(ii) On January 1, 1971, M makes a cash bonus award to A of $100x. On January 15, 1971, $20x, representing representing the first installment of the award, is paid to A. On January 15, 1972, $20x, representing the portion of the award earned out by A during the calendar year 1971 is paid to him. On January 1, 1972, A retires from employment with M and, having satisfied the conditions to continue earning out his bonus award, receives $20x on January 15, 1975.

(iii) Under the facts and circumstances, the conditions that A not conduct himself in a manner inimical to the best interests of M and refrain from activity competitive to that of M are not considered to result in a substantial risk of forfeiture of the bonus award. The total installments of $40x paid to A in 1971 and 1972 constitute earned income. The installment of $20x earned out by A in 1972 and paid to him in 1973 also constitutes earned income for the taxable year 1973 because it was includible in gross income by A before the end of the taxable year of A following the first taxable year (the year of his retirement, i.e., 1972) in which his right to receive the installment was not subject to a substantial risk of forfeiture. The installments paid to A in 1974 and 1975, however, do not constitute earned income because they were paid in a year later than the year following the year of A's retirement. Had the conditions that A not conduct himself in a manner inimical to the best interests of M and refrain from activity competitive to that of M constituted a substantial risk of forfeiture, the installments paid to A in 1974 and 1975 would have constituted earned income.

Example 6. On January 15, 1968, Corporation M, under the terms of a nonqualified bonus plan for its employees, grants to A, an employee, 5,000 *dividend units*, which entitle A to receive, for the period during which the award remains in effect, a cash payment equal to the dividends declared andpaid by M on the equivalent of 5,000 shares of its capital stock. The award remains in effect for A's lifetime but is subject to forfeiture if A is dismissed or leaves the service of M for any reason other than his death or retirement, or if A, following his retirement, engages in any activity which is harmful to the interests of M. Under the particular facts and circumstances, the condition that A not engage in any harmful activity is not considered to amount to a substantial risk of forfeiture within the meaning of section 83(c)(1). A retires on January 1, 1971. In each of the calendar years 1971, 1972, 1973, and 1974. A receives cash payments of $5x under his bonus award. The payments totaling $10x to A in the years 1971 and 1972 constitute earned income because A received them before the end of the taxable year following the first taxable year (i.e., 1971, the year in which A retired) in which his right to receive such payments was not subject to a substantial risk of forfeiture. Payments totaling $10x to A in 1973 and 1974, however, constitute deferred compensation under paragraph (b) of this section.

Example 7. Corporation M maintains an employees' profit sharing trust which is not exempt from tax under section 501(a). Under the terms of the trust agreement, the interest of the trust beneficiaries in each contribution made to the trust by M is subject to asubstantial risk of forfeiture for a period of 2 years from the date on which the particular contribution is made, except that upon a beneficiary's retirement, his entire interest in the trust vests immediately. Contributions are made on December 30 of each year. As of August 1, 1969, the total interest, forfeitable and nonforfeitable, of A, an employee of M, in the trust is $320x. On December 30 in each of the years 1969, 1970, and 1971, M makes a further contribution to the trust allocable to A's account equal to $60x. A retires on December 31, 1971, and becomes entitled to a total distribution from the trust of $500x, of which $320x represents M's contributions made prior to August 1, 1969, and $180x represents contributions made subsequent to such date. Beginning in 1972, the trust distributes to A $500x in 5 equal annual installments. Because M's contributions to A's account for the years subsequent to August 1, 1969, totaling $180x vested as of his retirement date, such contributions of $180x constitute earned income of A for the year 1971 by reason of § 1.402(b)–1(b). No portion of any annual installment of $100x which is includible in A's gross income constitutes earned income since it is attributable to the $320x, in all of which A's rights became nonforfeitable no later than December 30, 1970.

Example 8. Corporation M maintains a qualified noncontributory pension plan for the benefit of its employees. Under the terms of the plan, no employee has a vested right to receive any distribution under the plan prior to his retirement from the employment of M upon reaching the age of 65. A, an employee of M, reaches age 65 on June 15, 1972, and retires on June 30, 1972. Under the terms of the pension plan, A becomes entitled to receive a monthly pension of $5x, beginning on July 1, 1972. A receives pension payments totalling $30x in 1972, $60x in 1973, $60x in 1974, $60x in 1975, and $60x in 1976. The pension payments received by A in 1972 and 1973 constitute earned income within paragraph (b)(3)(ii) of this section. The pension payments received by A in 1974, 1975, and 1976 constitute deferred compensation.

Example 9. (i) A is a participant in X Corporation's noncontributory qualified pension plan. The plan provides an annual benefit upon attaining age 65 of 2 percent of average compensation for each calendar year of participation in the plan. Average compensation is defined as the average of an employee's annual compensation over the last 5 calendar years of service. The plan provides that an employee's rights in his accrued benefit are nonforfeitable after 15 years of participation in the plan. A attains age 65 on June 20, 1975 and begins to receive a pension on July 1, 1975. A's pension is based upon 30 years of participation in the plan. A's annual compensation for the period 1969 through 1974, is as follows:

Year	Annual Compensation
1969	$75,000
1970	80,000
1971	80,000
1972	85,000
1973	85,000
1974	90,000

(ii) Under the terms of the plan, A's accrued benefit as of December 31, 1974, and his pension are $50,400 (0.02 × 30 × ⅕ ($80,000 + $80,000 + $85,000 + $90,000)). A's accrued benefit as of December 31, 1973, is $46,980 (0.02 × 29 × ⅕ $85,000)). Since A's rights in $46,980 of his accrued benefit had ceased to be subject to a substantial risk of forfeiture before 1974, only $285 (1/12 × ($50,400 − $46,980)) of each payment received during 1975 does not constitute deferred compensation. The balance of the amounts received during 1975 and all amounts received in 1976 constitute deferred compensation since they are paid after the end of the taxable year following A's first taxable year in which his right to receive any such amount was not subject to a substantial risk of forfeiture.

Example 10. On January 15, 1971, Corporation M grants to A, an employee, an option to purchase 100 shares of stock of M at a price of $10x per share. Such option constitutes a qualified stock option constitutes a qualified stock option as defined in section 422(b). On August 1, 1971, A exercises his option, at which time the fair market value of the 100 shares of M Stock is $15x per share. On April 24, 1972, A sells the 100 shares of M stock acquired pursuant to exercise of his option at a price of $25x per share. Because the sale constitutes a disqualifying disposition within the meaning of section 421(b), A realizes ordinary income of $500x and a capital gain of $1,000x in the taxable year 1972. The $500x of ordinary income so realized by A constitutes earned income.

Example 11. On November 30, 1072, Corporation M grants to A, an employee, a nonqualified stock option to which section 421 does not apply and which has no readily ascertainable fair market value on that date. The option may, by its terms, be exercised by A at any time during, or following termination of, his employment. On March 30, 1974, A, while still employed by M, exercises his option and realizes compensation income at that time. Such compensation does not constitute earned income because the option is exercisable within a period that may extend beyond three months after A's termination of employment (other than by reason of death). See paragraph (b)(3)(iii)(B) of this section. Had A exercised his option at any time prior to January 1, 1974, the compensation realized by him by reason of such exercise would have constituted earned income.

Example 12. On November 30, 1972, Corporation N grants to B, an employee, a nonqualified stock option to which section 421 does not apply and which has no readily ascertainable fair market value on that date. The option may by its terms, be exercised only within the period during which B is employed by N or within three months thereafter. On March 30, 1974, B exercises his option and realizes compensation at that time. Such compensation so realized by B constitutes earned income. See paragraph (b)(3)(iii)(B) of this section.

Example 13. On May 9, 1973, and in connection with the performance of services by E, an employee, Corporation X transfers to E 100 shares of X stock. Under the terms of the transfer, E is subject to a binding commitment to return the stock to X if E leaves X's employment for any reason prior to the expiration of a 3-year period beginning on the date of transfer. Since E must perform substantial services for X before he may keep the X stock, E's rights in the stock are subject to a substantial risk of forfeiture under section 83(c)(1). Consequently, if such restriction lapses on May 9, 1976, the compensation realized at such time constitutes earned income. Had E elected to include an amount in his gross income in 1973 pursuant to section 83(b) and the regulations thereunder, the amount so included would also have constituted earned income.

Example 14. On October 1, 1971, A, an author, and Corporation M, a publisher, executed an agreement under which A granted to M the exclusive right to print, publish and sell a book he had written. The agreement provides that M will pay to A specified royalties based on the actual cash received from the sale of the published work, render semiannual statements of the sales, and at the time of rendering each statement make settlement for the amount due. On the same day, another agreement was signed by A and M, mutually agreeing that, in consideration of, and notwithstanding, any contrary provisions contained in the first contract, M shall not pay A more than $100x in any one calendar year. Under this supplemental contract, sums in excess of $100x accruing in any one calendar year are to be carried over by M into succeeding years. For the calendar year 1971, royalties payable to A under the basic agreement amount to $100x and this sum is paid to A. For the calendar year 1972, royalties of $120x are payable to A under the basic agreement, but by reason of the supplemental agreement, only $100x of this sum is actually paid to A. For each of the calendar years 1973 and 1974, royalties of $100x are payable to A under the basic agreement, and this sum is paid to A. For the calendar year 1975, royalties of $80x are payable to A under the basic agreement, and this sum, plus $20x carried over from 1972, or $100x, is paid to A. The $100x paid to A in each of the years 1971, 1972, 1973, and 1974, and $80x of the $100x paid to A in 1975 constitute earned income. The additional $20x carried over from 1972 and paid to A in 1975 constitutes deferred compensation under this paragraph (b) because it was paid to A later than the end of the year following the year (i.e., 1972) in which A's right to receive the amount was not subject to a substantial risk of forfeiture.

Example 15. Corporation M is the producer and owner of a feature length motion picture which is distributed to exhibitors by Corporation N pursuant to a distribution agreement between M and N providing for current payments to M of a given percentage of the current net profits derived by N from the exhibition and exploitation of the picture. A was employed by M as the leading actor in the picture for fixed compensation payable at the rate of $10x per week during the production period plus additional compensation equal to a given percentage of the net profits derived from the exhibition and exploitation of the picture. A's additional compensation is payable at the time that M receives payments from N under the terms of the distribution agreement. The additional compensation paid to A does not constitute deferred compensation since it is attributable to and measured by current net profits derived from the use of property created in part by A's efforts.

Example 16. A, a boxer entered into an agreement with M boxing club to fight a particular opponent on June 19, 1971. The agreement provided in part, that for his performance A was to receive 16 percent of the gross receipts derived from the match. Simultaneously, A and M executed a separate agreement providing for payment of A's share of the receipts from the match as follows: 25 percent thereof not later than August 15, 1971, and 25 percent thereof during each of the years 1972, 1973, and 1974 in equal semiannual installments. A's share of the gross receipts derived from the match was $100x, of which 25 percent was paid to him in 1971 and a total of $25x in each of the years 1972, 1973, and 1974. Under the particular facts and circumstances, A and M are not acting as partners or joint venturers. Thus, A is taxable upon his share of such gross receipts only in the years in which such share is actually paid to him under the terms of the separate agreement. The payments of $25x in each of the years 1971 and 1972 constitute earned income. The payments of $25x in each of the years 1973 and 1974 would not constitute earned income because they constitute deferred compensation received later than the end of the first taxable year (i.e., 1972) following the year in which A's right to receive such amounts was not subject to a substantial risk of forfeiture.

[T.D. 7446, 41 FR 55339, Dec. 20, 1976]

SMALL BUSINESS CORPORATIONS AND THEIR SHAREHOLDERS

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[T.D. 8600, 60 FR 37581, July 21, 1995, as amended by T.D. 8869, 65 FR 3848, Jan. 25, 2000; T.D. 8994, 67 FR 34397, May 14, 2002; T.D. 9422, 73 FR 47527, Aug. 14, 2008]

§ 1.1361–1 S corporation defined.

(a) *In general.* For purposes of this title, with respect to any taxable year—

(1) The term *S corporation* means a small business corporation (as defined in paragraph (b) of this section) for which an election under section 1362(a) is in effect for that taxable year.

(2) The term *C corporation* means a corporation that is not an S corporation for that taxable year.

(b) *Small business corporation defined*—(1) *In general.* For purposes of subchapter S, chapter 1 of the Code and the regulations thereunder, the term *small business corporation* means a domestic corporation that is not an ineligible corporation (as defined in section 1361(b)(2)) and that does not have—

(i) More than the number of shareholders provided in section 1361(b)(1)(A);

(ii) As a shareholder, a person (other than an estate, a trust described in section 1361(c)(2), or, for taxable years beginning after December 31, 1997, an organization described in section 1361(c)(6)) who is not an individual;

(iii) A nonresident alien as a shareholder; or

(iv) More than one class of stock.

(2) *Estate in bankruptcy.* The term *estate*, for purposes of this paragraph, includes the estate of an individual in a case under title 11 of the United States Code.

(3) *Treatment of restricted stock.* For purposes of subchapter S, stock that is issued in connection with the performance of services (within the meaning of § 1.83–3(f)) and that is substantially nonvested (within the meaning of § 1.83–3(b)) is not treated as outstanding stock of the corporation, and the holder of that stock is not treated as a shareholder solely by reason of holding the stock, unless the holder makes an election with respect to the stock under section 83(b). In the event of such an election, the stock is treated as outstanding stock of the corporation, and the holder of the stock is treated as a shareholder for purposes of subchapter S. See paragraphs (l) (1) and (3) of this section for rules for determining whether substantially nonvested stock with respect to which an election under section 83(b) has been made is treated as a second class of stock.

(4) *Treatment of deferred compensation plans.* For purposes of subchapter S, an instrument, obligation, or arrangement is not outstanding stock if it—

(i) Does not convey the right to vote;

(ii) Is an unfunded and unsecured promise to pay money or property in the future;

(iii) Is issued to an individual who is an employee in connection with the performance of services for the corporation or to an individual who is an independent contractor in connection with the performance of services for the corporation (and is not excessive by reference to the services performed); and

(iv) Is issued pursuant to a plan with respect to which the employee or independent contractor is not taxed currently on income.

A deferred compensation plan that has a current payment feature (e.g., payment of dividend equivalent amounts that are taxed currently as compensation) is not for that reason excluded from this paragraph (b)(4).

(5) *Treatment of straight debt.* For purposes of subchapter S, an instrument or obligation that satisfies the definition of straight debt in paragraph (l)(5) of this section is not treated as outstanding stock.

(6) *Effective date provision.* Section 1.1361–1(b) generally applies to taxable years of a corporation beginning on or after May 28, 1992. However, a corporation and its shareholders may apply this § 1.1361–1(b) to prior taxable years. In addition, substantially nonvested stock issued on or before May 28, 1992, that has been treated as outstanding by the corporation is treated as outstanding for purposes of subchapter S, and the fact that it is substantially nonvested and no section 83(b) election has been made with respect to it will not cause the stock to be treated as a second class of stock.

(c) *Domestic corporation.* For purposes of paragraph (b) of this section, the term *domestic corporation* means a domestic corporation as defined in § 301.7701–5 of this chapter, and the term *corporation* includes an entity

that is classified as an association taxable as a corporation under § 301.7701–2 of this chapter.

(d) *Ineligible corporation*—(1) *General rule*. Except as otherwise provided in this paragraph (d), the term *ineligible corporation* means a corporation that is—

(i) For taxable years beginning on or after January 1, 1997, a financial institution that uses the reserve method of accounting for bad debts described in section 585 (for taxable years beginning prior to January 1, 1997, a financial institution to which section 585 applies (or would apply but for section 585(c)) or to which section 593 applies);

(ii) An insurance company subject to tax under subchapter L;

(iii) A corporation to which an election under section 936 applies; or

(iv) A DISC or former DISC.

(2) *Exceptions*. See the special rules and exceptions provided in sections 6(c)(2), (3) and (4) of Public Law 97–354 that are applicable for certain casualty insurance companies and qualified oil corporations.

(e) *Number of shareholders*—(1) *General rule*. A corporation does not qualify as a small business corporation if it has more than the number of shareholders provided in section 1361(b)(1)(A). Ordinarily, the person who would have to include in gross income dividends distributed with respect to the stock of the corporation (if the corporation were a C corporation) is considered to be the shareholder of the corporation. For example, if stock (owned other than by a husband and wife or members of a family described in section 1361(c)(1)) is owned by tenants in common or joint tenants, each tenant in common or joint tenant is generally considered to be a shareholder of the corporation. (For special rules relating to stock owned by husband and wife or members of a family, see paragraphs (e)(2) and (3) of this section, respectively; for special rules relating to restricted stock, see paragraphs (b)(3) and (6) of this section.) The person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation for purposes of this paragraph (e) and paragraphs (f) and (g) of this section. For example, a partnership may be a nominee of S corporation stock for a person who qualifies as a shareholder of an S corporation. However, if the partnership is the beneficial owner of the stock, then the partnership is the shareholder, and the corporation does not qualify as a small business corporation. In addition, in the case of stock held for a minor under a uniform transfers to minors act or similar statute, the minor and not the custodian is the shareholder. Except as otherwise provided in paragraphs (h) and (j) of this section, and for purposes of this paragraph (e) and paragraphs (f) and (g) of this section, if stock is held by a decedent's estate or a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate or trust (and not the beneficiaries of the estate or trust) is considered to be the shareholder; however, if stock is held by a subpart E trust (which includes a voting trust) or an electing QSST described in section 1361(d)(1), the deemed owner of the trust is considered to be the shareholder. If stock is held by an ESBT described in section 1361(c)(2)(A)(v), each potential current beneficiary of the trust shall be treated as a shareholder, except that the trust shall be treated as the shareholder during any period in which there is no potential current beneficiary of the trust. If stock is held by a trust described in section 1361(c)(2)(A)(vi), the individual for whose benefit the trust was created shall be treated as the shareholder. See paragraph (h) of this section for special rules relating to trusts.

(2) *Special rules relating to stock owned by husband and wife*. For purposes of paragraph (e)(1) of this section, stock owned by a husband and wife (or by either or both of their estates) is treated as if owned by one shareholder, regardless of the form in which they own the stock. For example, if husband and wife are owners of a subpart E trust, they will be treated as one individual. Both husband and wife must be U.S. citizens or residents, and a decedent spouse's estate must not be a foreign estate as defined in section 7701(a)(31). The treatment described in this paragraph (e)(2) will cease upon dissolution of the marriage for any reason other than death.

(3) *Special rules relating to stock owned by members of a family*—(i) *In general.* For purposes of paragraph (e)(1) of this section, stock owned by members of a family is treated as owned by one shareholder. Members of a family include a common ancestor, any lineal descendant of the common ancestor (without any generational limit), and any spouse (or former spouse) of the common ancestor or of any lineal descendants of the common ancestor. An individual shall not be considered to be a common ancestor if, on the applicable date, the individual is more than six generations removed from the youngest generation of shareholders who would be members of the family determined by deeming that individual as the common ancestor. For purposes of this six-generation test, a spouse (or former spouse) is treated as being of the same generation as the individual to whom the spouse is or was married. This test is applied on the latest of the date the election under section 1362(a) is made for the corporation, the earliest date that a member of the family (determined by deeming that individual as the common ancestor) holds stock in the corporation, or October 22, 2004. For this purpose, the date the election under section 1362(a) is made for the corporation is the effective date of the election, not the date it is signed or received by any person. The test is only applied as of the applicable date, and lineal descendants (and spouses) more than six generations removed from the common ancestor will be treated as members of the family even if they acquire stock in the corporation after that date. The members of a family are treated as one shareholder under this paragraph (e)(3) solely for purposes of section 1361(b)(1)(A), and not for any other purpose, whether under section 1361 or any other provision. Specifically, each member of the family who owns or is deemed to own stock must meet the requirements of sections 1361(b)(1)(B) and (C) (regarding permissible shareholders) and section 1362(a)(2) (regarding shareholder consents to an S corporation election). Although a person may be a member of more than one family under this paragraph (e)(3), each family (not all of whose members are also members of the other family) will be treated as one shareholder. For purposes of this paragraph (e)(3), any legally adopted child of an individual, any child who is lawfully placed with an individual for legal adoption by that individual, and any eligible foster child of an individual (within the meaning of section 152(f)(1)(C)), shall be treated as a child of such individual by blood.

(ii) *Certain entities treated as members of a family.* For purposes of this paragraph (e)(3), the estate or trust (described in section 1361(c)(2)(A)(ii) or (iii)) of a deceased member of the family will be considered to be a member of the family during the period in which the estate or such trust (if the trust is described in section 1361(c)(2)(A)(ii) or (iii)), holds stock in the S corporation. The members of the family also will include—

(A) In the case of an ESBT, each potential current beneficiary who is a member of the family;

(B) In the case of a QSST, the income beneficiary who makes the QSST election, if that income beneficiary is a member of the family;

(C) In the case of a trust created primarily to exercise the voting power of stock transferred to it, each beneficiary who is a member of the family;

(D) The individual for whose benefit a trust described in section 1361(c)(2)(A)(vi) was created, if that individual is a member of the family;

(E) The deemed owner of a trust described in section 1361(c)(2)(A)(i) if that deemed owner is a member of the family; and

(F) The owner of an entity disregarded as an entity separate from its owner under § 301.7701–3 of this chapter, if that owner is a member of the family.

(f) *Shareholder must be an individual or estate.* Except as otherwise provided in paragraph (e)(1) of this section (relating to nominees), paragraph (h) of this section (relating to certain trusts), and, for taxable years beginning after December 31, 1997, section 1361(c)(6) (relating to certain exempt organizations), a corporation in which any shareholder is a corporation, partnership, or trust does not qualify as a small business corporation.

(g) *Nonresident alien shareholder*—(1) *General rule*. (i) A corporation having a shareholder who is a nonresident alien as defined in section 7701(b)(1)(B) does not qualify as a small business corporation. If a U.S. shareholder's spouse is a nonresident alien who has a current ownership interest (as opposed, for example, to a survivorship interest) in the stock of the corporation by reason of any applicable law, such as a state community property law or a foreign country's law, the corporation does not qualify as a small business corporation from the time the nonresident alien spouse acquires the interest in the stock. If a corporation's S election is inadvertently terminated as a result of a nonresident alien spouse being considered a shareholder, the corporation may request relief under section 1362(f).

(ii) The following examples illustrate this paragraph (g)(1)(i):

Example 1. In 1990, W, a U.S. citizen, married H, a citizen of a foreign country. At all times H is a nonresident alien under section 7701(b)(1)(B). Under the foreign country's law, all property acquired by a husband and wife during the existence of the marriage is community property and owned jointly by the husband and wife. In 1996 while residing in the foreign country, W formed X, a U.S. corporation, and X simultaneously filed an election to be an S corporation. X issued all of its outstanding stock in W's name. Under the foreign country's law, X's stock became the community property of and jointly owned by H and W. Thus, X does not meet the definition of a small business corporation and therefore could not file a valid S election because H, a nonresident alien, has a current interest in the stock.

Example 2. Assume the same facts as *Example 1*, except that in 1991, W and H filed a section 6013(g) election allowing them to file a joint U.S. tax return and causing H to be treated as a U.S. resident for purposes of chapters 1, 5, and 24 of the Internal Revenue Code. The section 6013(g) election applies to the taxable year for which made and to all subsequent taxable years until terminated. Because H is treated as a U.S. resident under section 6013(g), X does meet the definition of a small business corporation. Thus, the election filed by X to be an S corporation is valid.

(2) *Special rule for dual residents*. [Reserved]

(h) *Special rules relating to trusts*—(1) *General rule*. In general, a trust is not a permitted small business corporation shareholder. However, except as provided in paragraph (h)(2) of this section, the following trusts are permitted shareholders:

(i) *Qualified subpart E trust*. A trust all of which is treated (under subpart E, part I, subchapter J, chapter 1) as owned by an individual (whether or not the grantor) who is a citizen or resident of the United States (a qualified subpart E trust). This requirement applies only during the period that the trust holds S corporation stock.

(ii) *Subpart E trust ceasing to be a qualified subpart E trust after the death of deemed owner*. A trust that was a qualified subpart E trust immediately before the death of the deemed owner and that continues in existence after the death of the deemed owner, but only for the 2-year period beginning on the day of the deemed owner's death. A trust is considered to continue in existence if the trust continues to hold the stock pursuant to the terms of the will or the trust agreement, or if the trust continues to hold the stock during a period reasonably necessary to wind up the affairs of the trust. See §1.641(b)-3 for rules concerning the termination of trusts for federal income tax purposes.

(iii) *Electing qualified subchapter S trusts*. A qualified subchapter S trust (QSST) that has a section 1361(d)(2) election in effect (an electing QSST). See paragraph (j) of this section for rules concerning QSSTs including the manner for making the section 1361(d)(2) election.

(iv) *Testamentary trusts*. A trust (other than a qualified subpart E trust, an electing QSST, or an electing small business trust) to which S corporation stock is—

(A) Transferred pursuant to the terms of a will, but only for the 2-year period beginning on the day the stock is transferred to the trust except as otherwise provided in paragraph (h)(3)(i)(D) of this section; or

(B) Transferred pursuant to the terms of an electing trust as defined in §1.645–1(b)(2) during the election period as defined in §1.645–1(b)(6), or deemed to be distributed at the close of the last day of the election period pursuant to §1.645–1(h)(1), but in each case only for the 2-year period beginning on the day the stock is transferred or deemed

distributed to the trust except as otherwise provided in paragraph (h)(3)(i)(D) of this section.

(v) *Qualified voting trusts.* A trust created primarily to exercise the voting power of S corporation stock transferred to it. To qualify as a voting trust for purposes of this section (a qualified voting trust), the beneficial owners must be treated as the owners of their respective portions of the trust under subpart E and the trust must have been created pursuant to a written trust agreement entered into by the shareholders, that—

(A) Delegates to one or more trustees the right to vote;

(B) Requires all distributions with respect to the stock of the corporation held by the trust to be paid to, or on behalf of, the beneficial owners of that stock;

(C) Requires title and possession of that stock to be delivered to those beneficial owners upon termination of the trust; and

(D) Terminates, under its terms or by state law, on or before a specific date or event.

(vi) *Electing small business trusts.* An electing small business trust (ESBT) under section 1361(e). See paragraph (m) of this section for rules concerning ESBTs including the manner of making the election to be an ESBT under section 1361(e)(3).

(vii) *Individual retirement accounts.* In the case of a corporation which is a bank (as defined in section 581) or a depository institution holding company (as defined in section 3(w)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(w)(1)), a trust which constitutes an individual retirement account under section 408(a), including one designated as a Roth IRA under section 408A, but only to the extent of the stock held by such trust in such bank or company as of October 22, 2004. Individual retirement accounts (including Roth IRAs) are not otherwise eligible S corporation shareholders.

(2) *Foreign trust.* For purposes of paragraph (h)(1) of this section, in any case where stock is held by a foreign trust as defined in section 7701(a)(31), the trust is considered to be the shareholder and is an ineligible shareholder. Thus, even if a foreign trust qualifies as a subpart E trust (e.g., a qualified voting trust), any corporation in which the trust holds stock does not qualify as a small business corporation.

(3) *Determination of shareholders*—(i) *General rule.* For purposes of paragraph (b) of this section (qualification as a small business corporation), and, except as provided in paragraph (h)(3)(ii) of this section, for purposes of sections 1366 (relating to the pass-through of items of income, loss, deduction, or credit), 1367 (relating to adjustments to basis of shareholder's stock), and 1368 (relating to distributions), the shareholder of S corporation stock held by a trust that is a permitted shareholder under paragraph (h)(1) of this section is determined as follows:

(A) If stock is held by a qualified subpart E trust, the deemed owner of the trust is treated as the shareholder.

(B) If stock is held by a trust defined in paragraph (h)(1)(ii) of this section, the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner's death. However, if stock is held by such a trust in a community property state, the decedent's estate is the shareholder only of the portion of the trust included in the decedent's gross estate (and the surviving spouse continues to be the shareholder of the portion of the trust owned by that spouse under the applicable state's community property law). The estate ordinarily will cease to be treated as the shareholder upon the earlier of the transfer of the stock by the trust or the expiration of the 2-year period beginning on the day of the deemed owner's death. If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election, and the rules provided in paragraph (j)(7) of this section apply. If the trust qualifies and becomes an ESBT, the shareholders are determined under paragraphs (h)(3)(i)(F) and (h)(3)(ii) of this section as of the effective date of the ESBT election, and the rules provided in paragraph (m) of this section apply.

(C) If stock is held by an electing QSST, see paragraph (j)(7) of this section for the rules on who is treated as the shareholder.

(D) If stock is transferred or deemed distributed to a testamentary trust described in paragraph (h)(1)(iv) of this section (other than a qualified subpart E trust, an electing QSST, or an ESBT), the estate of the testator is treated as the shareholder until the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day that the stock is transferred or deemed distributed to the trust. If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election, and the rules provided in paragraph (j)(7) of this section apply. If the trust qualifies and becomes an ESBT, the shareholders are determined under paragraphs (h)(3)(i)(F) and (h)(3)(ii) of this section as of the effective date of the ESBT election, and the rules provided in paragraph (m) of this section apply.

(E) If stock is held by a qualified voting trust, each beneficial owner of the stock, as determined under subpart E, is treated as a shareholder with respect to the owner's proportionate share of the stock held by the trust.

(F) If S corporation stock is held by an ESBT, each potential current beneficiary is treated as a shareholder. However, if for any period there is no potential current beneficiary of the ESBT, the ESBT is treated as the shareholder during such period. See paragraph (m)(4) of this section for the definition of potential current beneficiary.

(G) If stock in an S corporation bank or depository institution holding company is held by an individual retirement account (including a Roth IRA) described in paragraph (h)(1)(vii) of this section, the individual for whose benefit the trust was created shall be treated as the shareholder.

(ii) *Exceptions. See* §1.641(c)–1 for the rules for the taxation of an ESBT. Solely for purposes of section 1366, 1367, and 1368 the shareholder of S corporation stock held by a trust is determined as follows—

(A) If stock is held by a trust as defined in paragraph (h)(1)(ii) of this section (other than an electing QSST or an ESBT), the trust is treated as the shareholder. If the trust continues to own the stock after the expiration of the 2-year period, the corporation's S election will terminate unless the trust is otherwise a permitted shareholder.

(B) If stock is transferred or deemed distributed to a testamentary trust described in paragraph (h)(1)(iv) of this section (other than a qualified subpart E trust, an electing QSST, or an ESBT), the trust is treated as the shareholder. If the trust continues to own the stock after the expiration of the 2-year period, the corporation's S election will terminate unless the trust otherwise qualifies as a permitted shareholder.

(i) [Reserved]

(j) *Qualified subchapter S trust*—(1) *Definition*. A qualified subchapter S trust (QSST) is a trust (whether intervivos or testamentary), other than a foreign trust described in section 7701(a)(31), that satisfies the following requirements:

(i) All of the income (within the meaning of §1.643(b)–1) of the trust is distributed (or is required to be distributed) currently to one individual who is a citizen or resident of the United States. For purposes of the preceding sentence, unless otherwise provided under local law (including pertinent provisions of the governing instrument that are effective under local law), income of the trust includes distributions to the trust from the S corporation for the taxable year in question, but does not include the trust's pro rata share of the S corporation's items of income, loss, deduction, or credit determined under section 1366. See §§1.651(a)–2(a) and 1.663(b)–1(a) for rules relating to the determination of whether all of the income of a trust is distributed (or is required to be distributed) currently. If under the terms of the trust income is not required to be distributed currently, the trustee may elect under section 663(b) to consider a distribution made in the first 65 days of a taxable year as made on the last day of the preceding taxable year. See section 663(b) and §1.663(b)–2 for rules on the time and manner for making the election. The income distribution requirement must be satisfied for the taxable year of the trust or for that part of the trust's taxable year during which it holds S corporation stock.

(ii) The terms of the trust must require that—

(A) During the life of the current income beneficiary, there will be only one income beneficiary of the trust;

(B) Any corpus distributed during the life of the current income beneficiary may be distributed only to that income beneficiary;

(C) The current income beneficiary's income interest in the trust will terminate on the earlier of that income beneficiary's death or the termination of the trust; and

(D) Upon termination of the trust during the life of the current income beneficiary, the trust will distribute all of its assets to that income beneficiary.

(iii) The terms of the trust must satisfy the requirements of paragraph (j)(1)(ii) of this section from the date the QSST election is made or from the effective date of the QSST election, whichever is earlier, throughout the entire period that the current income beneficiary and any successor income beneficiary is the income beneficiary of the trust. If the terms of the trust do not preclude the possibility that any of the requirements stated in paragraph (j)(1)(ii) of this section will not be met, the trust will not qualify as a QSST. For example, if the terms of the trust are silent with respect to corpus distributions, and distributions of corpus to a person other than the current income beneficiary are permitted under local law during the life of the current income beneficiary, then the terms of the trust do not preclude the possibility that corpus may be distributed to a person other than the current income beneficiary and, therefore, the trust is not a QSST.

(2) *Special rules*—(i) If a husband and wife are income beneficiaries of the same trust, the husband and wife file a joint return, and each is a U.S. citizen or resident, the husband and wife are treated as one beneficiary for purposes of paragraph (j) of this section. If a husband and wife are treated by the preceding sentence as one beneficiary, any action required by this section to be taken by an income beneficiary requires joinder of both of them. For example, each spouse must sign the QSST election, continue to be a U.S. citizen or resident, and continue to file joint returns for the entire period that the QSST election is in effect.

(ii)(A) *Terms of the trust and applicable local law.* The determination of whether the terms of a trust meet all of the requirements under paragraph (j)(1)(ii) of this section depends upon the terms of the trust instrument and the applicable local law. For example, a trust whose governing instrument provides that A is the sole income beneficiary of the trust is, nevertheless, considered to have two income beneficiaries if, under the applicable local law, A and B are considered to be the income beneficiaries of the trust.

(B) *Legal obligation to support.* If under local law a distribution to the income beneficiary is in satisfaction of the grantor's legal obligation of support to that income beneficiary, the trust will not qualify as a QSST as of the date of distribution because, under section 677(b), if income is distributed, the grantor will be treated as the owner of the ordinary income portion of the trust or, if trust corpus is distributed, the grantor will be treated as a beneficiary under section 662. See §1.677(b)–1 for rules on the treatment of trusts for support and §1.662(a)–4 for rules concerning amounts used in discharge of a legal obligation.

(C) *Example.* The following example illustrates the rules of paragraph (j)(2)(ii)(B) of this section:

Example: F creates a trust for the benefit of F's minor child, G. Under the terms of the trust, all income is payable to G until the trust terminates on the earlier of G's attaining age 35 or G's death. Upon the termination of the trust, all corpus must be distributed to G or G's estate. The trust includes all of the provisions prescribed by section 1361(d)(3)(A) and paragraph (j)(1)(ii) of this section, but does not preclude the trustee from making income distributions to G that will be in satisfaction of F's legal obligation to support G. Under the applicable local law, distributions of trust income to G will satisfy F's legal obligation to support G. If the trustee distributes income to G in satisfaction of F's legal obligation to support G, the trust will not qualify as a QSST because F will be treated as the owner of the ordinary income portion of the trust. Further, the trust will not be a qualified subpart E trust because the trust will be subject to tax on the income allocable to corpus.

(iii) If, under the terms of the trust, a person (including the income beneficiary) has a special power to appoint, during the life of the income beneficiary, trust income or corpus to any person other than the current income beneficiary, the trust will not qualify as a QSST. However, if the power of appointment results in the grantor being treated as the owner of the entire trust under the rules of subpart E, the trust may be a permitted shareholder under section 1361 (c)(2)(A)(i) and paragraph (h)(1)(i) of this section.

(iv) If the terms of a trust or local law do not preclude the current income beneficiary from transferring the beneficiary's interest in the trust or do not preclude a person other than the current income beneficiary named in the trust instrument from being treated as a beneficiary of the trust under § 1.643(c)–1, the trust will still qualify as a QSST. However, if the income beneficiary transfers or assigns the income interest or a portion of the income interest to another, the trust may no longer qualify as a QSST, depending on the facts and circumstances, because any transferee of the current income beneficiary's income interest and any person treated as a beneficiary under § 1.643(c)–1 will be treated as a current income beneficiary for purposes of paragraph (j)(1)(ii) of this section and the trust may no longer meet the QSST requirements.

(v) If the terms of the trust do not preclude a person other than the current income beneficiary named in the trust instrument from being awarded an interest in the trust by the order of a court, the trust will qualify as a QSST assuming the trust meets the requirements of paragraphs (j)(1) (i) and (ii) of this section. However, if as a result of such court order, the trust no longer meets the QSST requirements, the trust no longer qualifies as a QSST and the corporation's S election will terminate.

(vi) A trust may qualify as a QSST even though a person other than the current income beneficiary is treated under subpart E as the owner of a part or all of that portion of a trust which does not consist of the S corporation stock, provided the entire trust meets the QSST requirements stated in paragraphs (j)(1) (i) and (ii) of this section.

(3) *Separate and independent shares of a trust.* For purposes of sections 1361 (c) and (d), a substantially separate and independent share of a trust, within the meaning of section 663(c) and the regulations thereunder, is treated as a separate trust. For a separate share which holds S corporation stock to qualify as a QSST, the terms of the trust applicable to that separate share must meet the QSST requirements stated in paragraphs (j)(1) (i) and (ii) of this section.

(4) *Qualified terminable interest property trust.* If property, including S corporation stock, or stock of a corporation that intends to make an S election, is transferred to a trust and an election is made to treat all or a portion of the transferred property as qualified terminable interest property (QTIP) under section 2056(b)(7), the income beneficiary may make the QSST election if the trust meets the requirements set out in paragraphs (j)(1) (i) and (ii) of this section. However, if property is transferred to a QTIP trust under section 2523(f), the income beneficiary may not make a QSST election even if the trust meets the requirements set forth in paragraph (j)(1)(ii) of this section because the grantor would be treated as the owner of the income portion of the trust under section 677. In addition, if property is transferred to a QTIP trust under section 2523(f), the trust does not qualify as a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section (a qualified subpart E trust), unless under the terms of the QTIP trust, the grantor is treated as the owner of the entire trust under sections 671 to 677. If the grantor ceases to be the income beneficiary's spouse, the trust may qualify as a QSST if it otherwise satisfies the requirements under paragraphs (j)(1) (i) and (ii) of this section.

(5) *Ceasing to meet the QSST requirements.* If a QSST for which an election under section 1361(d)(2) has been made (as described in paragraph (j)(6) of this section) ceases to meet any of the requirements specified in paragraph (j)(1)(ii) of this section, the provisions of this paragraph (j) will cease to apply

as of the first day on which that requirement ceases to be met. If such a trust ceases to meet the income distribution requirement specified in paragraph (j)(1)(i) of this section, but continues to meet all of the requirements in paragraph (j)(1)(ii) of this section, the provisions of this paragraph (j) will cease to apply as of the first day of the first taxable year beginning after the first taxable year for which the trust ceased to meet the income distribution requirement of paragraph (j)(1)(i) of this section. If a corporation's S election is inadvertently terminated as a result of a trust ceasing to meet the QSST requirements, the corporation may request relief under section 1362(f).

(6) *Qualified subchapter S trust election*—(i) *In general*. This paragraph (j)(6) applies to the election provided in section 1361(d)(2) (the QSST election) to treat a QSST (as defined in paragraph (j)(1) of this section) as a trust described in section 1361(c)(2)(A)(i), and thus a permitted shareholder. This election must be made separately with respect to each corporation whose stock is held by the trust. The QSST election does not itself constitute an election as to the status of the corporation; the corporation must make the election provided by section 1362(a) to be an S corporation. Until the effective date of a corporation's S election, the beneficiary is not treated as the owner of the stock of the corporation for purposes of section 678. Any action required by this paragraph (j) to be taken by a person who is under a legal disability by reason of age may be taken by that person's guardian or other legal representative, or if there be none, by that person's natural or adoptive parent.

(ii) *Filing the QSST election*. The current income beneficiary of the trust must make the election by signing and filing with the service center with which the corporation files its income tax return the applicable form or a statement that—

(A) Contains the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation;

(B) Identifies the election as an election made under section 1361(d)(2);

(C) Specifies the date on which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed);

(D) Specifies the date (or dates) on which the stock of the corporation was transferred to the trust; and

(E) Provides all information and representations necessary to show that:

(*1*) Under the terms of the trust and applicable local law—

(*i*) During the life of the current income beneficiary, there will be only one income beneficiary of the trust (if husband and wife are beneficiaries, that they will file joint returns and that both are U.S. residents or citizens);

(*ii*) Any corpus distributed during the life of the current income beneficiary may be distributed only to that beneficiary;

(*iii*) The current beneficiary's income interest in the trust will terminate on the earlier of the beneficiary's death or upon termination of the trust; and

(*iv*) Upon the termination of the trust during the life of such income beneficiary, the trust will distribute all its assets to such beneficiary.

(*2*) The trust is required to distribute all of its income currently, or that the trustee will distribute all of its income currently if not so required by the terms of the trust.

(*3*) No distribution of income or corpus by the trust will be in satisfaction of the grantor's legal obligation to support or maintain the income beneficiary.

(iii) *When to file the QSST election*. (A) If S corporation stock is transferred to a trust, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust. If a C corporation has made an election under section 1362(a) to be an S corporation (S election) and, before that corporation's S election is in effect, stock of that corporation is transferred to a trust, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust.

(B) If a trust holds C corporation stock and that C corporation makes an S election effective for the first day of

the taxable year in which the S election is made, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the S election is effective. If a trust holds C corporation stock and that C corporation makes an S election effective for the first day of the taxable year following the taxable year in which the S election is made, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the S election is made. If a trust holds C corporation stock and that corporation makes an S election intending the S election to be effective for the first day of the taxable year in which the S election is made but, under § 1.1362–6(a)(2), such S election is subsequently treated as effective for the first day of the taxable year following the taxable year in which the S election is made, the fact that the QSST election states that the effective date of the QSST election is the first day of the taxable year in which the S election is made will not cause the QSST election to be ineffective for the first year in which the corporation's S election is effective.

(C) If a trust ceases to be a qualified subpart E trust, satisfies the requirements of a QSST, and intends to become a QSST, the QSST election must be filed within the 16-day-and-2-month period beginning on the date on which the trust ceases to be a qualified subpart E trust. If the estate of the deemed owner of the trust is treated as the shareholder under paragraph (h)(3)(i) of this section, the QSST election may be filed at any time, but no later than the end of the 16-day-and-2-month period beginning on the date on which the estate of the deemed owner ceases to be treated as a shareholder.

(D) If a testamentary trust is a permitted shareholder under paragraph (h)(1)(iv) of this section, satisfies the requirements of a QSST, and intends to become a QSST, the QSST election may be filed at any time, but no later than the end of the 16-day-and-2-month period beginning on the day after the end of the 2-year period.

(E) If a corporation's S election terminates because of a late QSST election, the corporation may request inadvertent termination relief under section 1362(f). See § 1.1362–4 for rules concerning inadvertent terminations.

(iv) *Protective QSST election when a person is an owner under subpart E.* If the grantor of a trust is treated as the owner under subpart E of all of the trust, or of a portion of the trust which consists of S corporation stock, and the current income beneficiary is not the grantor, the current income beneficiary may not make the QSST election, even if the trust meets the QSST requirements stated in paragraph (j)(1)(ii) of this section. See paragraph (j)(6)(iii)(C) of this section as to when the QSST election may be made. See also paragraph (j)(2)(vi) of this section. However, if the current income beneficiary (or beneficiaries who are husband and wife, if both spouses are U.S. citizens or residents and file a joint return) of a trust is treated under subpart E as owning all or a portion of the trust consisting of S corporation stock, the current income beneficiary (or beneficiaries who are husband and wife, if both spouses are U.S. citizens or residents and file a joint return) may make the QSST election. See *Example 8* of paragraph (k)(1) of this section.

(7) *Treatment as shareholder.* (i) The income beneficiary who makes the QSST election and is treated (for purposes of section 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) If, upon the death of an income beneficiary, the trust continues in existence, continues to hold S corporation stock but no longer satisfies the QSST requirements, is not a qualified subpart E trust, and does not qualify as an ESBT, then, solely for purposes of section 1361(b)(1), as of the date of the income beneficiary's death, the estate of that income beneficiary is treated as the shareholder of the S corporation with respect to which the income beneficiary made the QSST election. The estate ordinarily will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day of the income beneficiary's death. During the period

that the estate is treated as the shareholder for purposes of section 1361(b)(1), the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368. If, after the 2-year period, the trust continues to hold S corporation stock and does not otherwise qualify as a permitted shareholder, the corporation's S election terminates. If the termination is inadvertent, the corporation may request relief under section 1362(f).

(8) *Coordination with grantor trust rules.* If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made. However, solely for purposes of applying the preceding sentence to a QSST, an income beneficiary who is a deemed section 678 owner only by reason of section 1361(d)(1) will not be treated as the owner of the S corporation stock in determining and attributing the Federal income tax consequences of a disposition of the stock by the QSST. For example, if the disposition is a sale, the QSST election terminates as to the stock sold and any gain or loss recognized on the sale will be that of the trust, not the income beneficiary. Similarly, if a QSST distributes its S corporation stock to the income beneficiary, the QSST election terminates as to the distributed stock and the consequences of the distribution are determined by reference to the status of the trust apart from the income beneficiary's terminating ownership status under sections 678 and 1361(d)(1). The portions of the trust other than the portion consisting of S corporation stock are subject to subparts A through D of subchapter J of chapter 1, except as otherwise required by subpart E of the Internal Revenue Code. However, solely for purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST shall be treated as a disposition by the income beneficiary.

(9) *Successive income beneficiary.* (i) If the income beneficiary of a QSST who made a QSST election dies, each successive income beneficiary of that trust is treated as consenting to the election unless a successive income beneficiary affirmatively refuses to consent to the election. For this purpose, the term *successive income beneficiary* includes a beneficiary of a trust whose interest is a separate share within the meaning of section 663(c), but does not include any beneficiary of a trust that is created upon the death of the income beneficiary of the QSST and which is a new trust under local law.

(ii) The application of this paragraph (j)(9) is illustrated by the following examples:

Example 1. Shares of stock in Corporation X, an S corporation, are held by Trust A, a QSST for which a QSST election was made. B is the sole income beneficiary of Trust A. On B's death, under the terms of Trust A, J and K become the current income beneficiaries of Trust A. J and K each hold a separate and independent share of Trust A within the meaning of section 663(c). J and K are successive income beneficiaries of Trust A, and they are treated as consenting to B's QSST election.

Example 2. Assume the same facts as in *Example 1,* except that on B's death, under the terms of Trust A and local law, Trust A terminates and the principal is to be divided equally and held in newly created Trust B and Trust C. The sole income beneficiaries of Trust B and Trust C are J and K, respectively. Because Trust A terminated, J and K are not successive income beneficiaries of Trust A. J and K must make QSST elections for their respective trusts to qualify as QSSTs, if they qualify. The result is the same whether or not the trustee of Trusts B and C is the same as the trustee of trust A.

(10) *Affirmative refusal to consent*—(i) *Required statement.* A successive income beneficiary of a QSST must make an affirmative refusal to consent by signing and filing with the service center where the corporation files its income tax return a statement that—

(A) Contains the name, address, and taxpayer identification number of the successive income beneficiary, the trust, and the corporation for which the election was made;

(B) Identifies the refusal as an affirmative refusal to consent under section 1361(d)(2); and

(C) Sets forth the date on which the successive income beneficiary became the income beneficiary.

(ii) *Filing date and effectiveness.* The affirmative refusal to consent must be

filed within 15 days and 2 months after the date on which the successive income beneficiary becomes the income beneficiary. The affirmative refusal to consent will be effective as of the date on which the successive income beneficiary becomes the current income beneficiary.

(11) *Revocation of QSST election.* A QSST election may be revoked only with the consent of the Commissioner. The Commissioner will not grant a revocation when one of its purposes is the avoidance of Federal income taxes or when the taxable year is closed. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request under the appropriate revenue procedure. The application must be signed by the current income beneficiary and must—

(i) Contain the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation with respect to which the QSST election was made;

(ii) Identify the election being revoked as an election made under section 1361(d)(2); and

(iii) Explain why the current income beneficiary seeks to revoke the QSST election and indicate that the beneficiary understands the consequences of the revocation.

(12) *Converting a QSST to an ESBT.* For a trust that seeks to convert from a QSST to an ESBT, the consent of the Commissioner is hereby granted to revoke the QSST election as of the effective date of the ESBT election, if all the following requirements are met:

(i) The trust meets all of the requirements to be an ESBT under paragraph (m)(1) of this section except for the requirement under paragraph (m)(1)(iv)(A) of this section that the trust not have a QSST election in effect.

(ii) The trustee and the current income beneficiary of the trust sign the ESBT election. The ESBT election must be filed with the service center where the S corporation files its income tax return. This ESBT election must state at the top of the document ''ATTENTION ENTITY CONTROL—CONVERSION OF A QSST TO AN ESBT PURSUANT TO SECTION 1.1361–1(j)'' and include all information otherwise required for an ESBT election under paragraph (m)(2) of this section. A separate election must be made with respect to the stock of each S corporation held by the trust.

(iii) The trust has not converted from an ESBT to a QSST within the 36-month period preceding the effective date of the new ESBT election.

(iv) The date on which the ESBT election is to be effective cannot be more than 15 days and two months prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 15 days and two months prior to the date on which the election is filed, it will be effective on the day that is 15 days and two months prior to the date on which it is filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective on the day that is 12 months after the date it is filed.

(k)(1) *Examples.* The provisions of paragraphs (h) and (j) of this section are illustrated by the following examples in which it is assumed that all noncorporate persons are citizens or residents of the United States:

Example 1. (i) *Terms of the trust.* In 1996, A and A's spouse, B, created an intervivos trust and each funded the trust with separately owned stock of an S corporation. Under the terms of the trust, A and B designated themselves as the income beneficiaries and each, individually, retained the power to amend or revoke the trust with respect to the trust assets attributable to their respective trust contributions. Upon A's death, the trust is to be divided into two separate parts; one part attributable to the assets A contributed to the trust and one part attributable to B's contributions. Before the trust is divided, and during the administration of A's estate, all trust income is payable to B. The part of the trust attributable to B's contributions is to continue in trust under the terms of which B is designated as the sole income beneficiary and retains the power to amend or revoke the trust. The part attributable to A's contributions is to be divided into two separate trusts both of which have B as the sole income beneficiary for life. One trust, the *Credit Shelter Trust*, is to be funded with an amount that can pass free of estate tax by reason of A's available estate tax unified credit. The terms of the Credit Shelter Trust meet the requirements of section 1361(d)(3) as

a QSST. The balance of the property passes to a Marital Trust, the terms of which satisfy the requirements of section 1361(d)(3) as a QSST and section 2056(b)(7) as QTIP. The appropriate fiduciary under §20.2056(b)–7(b)(3) is directed to make an election under section 2056(b)(7).

(ii) *Results after deemed owner's death.* On February 3, 1997, A dies and the portion of the trust assets attributable to A's contributions including the S stock contributed by A, is includible in A's gross estate under sections 2036 and 2038. During the administration of A's estate, the trust holds the S corporation stock. Under section 1361(c)(2)(B)(ii), A's estate is treated as the shareholder of the S corporation stock that was included in A's gross estate for purposes of section 1361(b)(1); however, for purposes of sections 1366, 1367, and 1368, the trust is treated as the shareholder. B's part of the trust continues to be a qualified subpart E trust of which B is the owner under sections 676 and 677. B, therefore, continues to be treated as the shareholder of the S corporation stock in that portion of the trust. On May 13, 1997, during the continuing administration of A's estate, the trust is divided into separate trusts in accordance with the terms of the trust instrument. The S corporation stock that was included in A's gross estate is distributed to the Marital Trust and to the Credit Shelter Trust. A's estate will cease to be treated as the shareholder of the S corporation under section 1361(c)(2)(B)(ii) on May 13, 1997 (the date on which the S corporation stock was transferred to the trusts). B, as the income beneficiary of the Marital Trust and the Credit Shelter Trust, must make the QSST election for each trust by July 28, 1997 (the end of the 16-day-and-2-month period beginning on the date the estate ceases to be treated as a shareholder) to have the trusts become permitted shareholders of the S corporation.

Example 2. (i) *Qualified subpart E trust as shareholder.* In 1997, A, an individual established a trust and transferred to the trust A's shares of stock of Corporation M, an S corporation. A has the power to revoke the entire trust. The terms of the trust require that all income be paid to B and otherwise meet the requirements of a QSST under section 1361(d)(3). The trust will continue in existence after A's death. The trust is a qualified subpart E trust described in section 1361(c)(2)(A)(i) during A's life, and A (not the trust) is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *Trust ceasing to be a qualified subpart E trust on deemed owner's death.* Assume the same facts as paragraph (i) of this *Example 2,* except that A dies without having exercised A's power to revoke. Upon A's death, the trust ceases to be a qualified subpart E trust described in section 1361(c)(2)(A)(i). A's estate (and not the trust) is treated as the shareholder for purposes of section 1361(b)(1). A's estate will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of the Corporation M stock by the trust (other than to A's estate), the expiration of the 2-year period beginning on the day of A's death, or the effective date of a QSST or ESBT election if the trust qualifies as a QSST or ESBT. However, until that time, because the trust continues in existence after A's death and will receive any distributions with respect to the stock it holds, the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368. If no QSST or ESBT election is made effective upon the expiration of the 2-year period, the corporation ceases to be an S corporation, but the trust continues as the shareholder of a C corporation.

(iii) *Trust continuing to be a qualified subpart E trust on deemed owner's death.* Assume the same facts as paragraph (ii) of this *Example 2,* except that the terms of the trust also provide that if A does not exercise the power to revoke before A's death, B will have the sole power to withdraw all trust property at any time after A's death. The trust continues to qualify as a qualified subpart E trust after A's death because, upon A's death, B is deemed to be the owner of the entire trust under section 678. Because the trust does not cease to be a qualified subpart E trust upon A's death, B (and not A's estate) is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368. Since the trust qualifies as a QSST, B may make a protective QSST election under paragraph (j)(6)(iv) of this section.

Example 3. (i) *2-year rule under section 1361(c)(2)(A)(ii) and (iii).* F owns stock of Corporation P, an S corporation. In addition, F is the deemed owner of a qualified subpart E trust that holds stock in Corporation O, an S corporation. F dies on July 1, 2003. The trust continues in existence after F's death but is no longer a qualified subpart E trust. On August 1, 2003, F's shares of stock in Corporation P are transferred to the trust pursuant to the terms of F's will. Because the stock of Corporation P was not held by the trust when F died, section 1361(c)(2)(A)(ii) does not apply with respect to that stock. Under section 1361(c)(2)(A)(iii), the last day on which the trust could be treated as a permitted shareholder of Corporation P is July 31, 2005 (that is, the last day of the 2-year period that begins on the date of the transfer from the estate to the trust). With respect to the shares of stock in Corporation O held by the trust at the time of F's death, section 1361(c)(2)(A)(ii) applies and the last day on which the trust could be treated as a permitted shareholder of Corporation O is June 30, 2005 (that is, the last day of the 2-year period that begins on the date of F's death).

(ii) *Section 645 electing trust and successor trust.* Assume the same facts as in paragraph (i) of this *Example 3,* except that F's trust is a qualified revocable trust for which a valid section 645 election is made on October 1, 2003 (electing trust). Because under section 645 the electing trust is treated and taxed for purposes of subtitle A of the Code as part of F's estate, the trust may continue to hold the O stock pursuant to §1361(b)(1)(B), without causing the termination of Corporation O's S election, for the duration of the section 645 election period. However, on January 1, 2004, during the election period, the shares of stock in Corporation O are transferred pursuant to the terms of the electing trust to a successor trust. Because the successor trust satisfies the definition of a testamentary trust under paragraph (h)(1)(iv) of this section, the successor trust is a permitted shareholder until the earlier of the expiration of the 2-year period beginning on January 1, 2004, or the effective date of a QSST or ESBT election for the successor trust.

Example 4. (i) *QSST when terms do not require current distribution of income.* Corporation Q, a calendar year corporation, makes an election to be an S corporation effective for calendar year 1996. On July 1, 1996, G, a shareholder of Corporation Q, transfers G's shares of Corporation Q stock to a trust with H as its current income beneficiary. The terms of the trust otherwise satisfy the QSST requirements, but authorize the trustee in its discretion to accumulate or distribute the trust income. However, the trust, which uses the calendar year as its taxable year, initially satisfies the income distribution requirement because the trustee is currently distributing all of the income. On August 1, 1996, H makes a QSST election with respect to Corporation Q that is effective as of July 1, 1996. Accordingly, as of July 1, 1996, the trust is a QSST and H is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *QSST when trust income is not distributed currently.* Assume the same facts as in paragraph (i) of this *Example 4,* except that, for the taxable year ending on December 31, 1997, the trustee accumulates some trust income. The trust ceases to be a QSST on January 1, 1998, because the trust failed to distribute all of its income for the taxable year ending December 31, 1997. Thus, Corporation Q ceases to be an S corporation as of January 1, 1998, because the trust is not a permitted shareholder.

(iii) *QSST when a person other than the current income beneficiary may receive trust corpus.* Assume the same facts as in paragraph (i) of this *Example 4,* except that the events occur in 2003 and H dies on November 1, 2003, and the trust does not qualify as an ESBT. Under the terms of the trust, after H's death, L is the income beneficiary of the trust and the trustee is authorized to distribute trust corpus to L as well as to J. The trust ceases to be a QSST as of November 1, 2003, because corpus distributions may be made to someone other than L, the current (successive) income beneficiary. Under section 1361(c)(2)(B)(ii), H's estate (and not the trust) is considered to be the shareholder for purposes of section 1361(b)(1) for the 2-year period beginning on November 1, 2003. However, because the trust continues in existence after H's death and will receive any distributions from the corporation, the trust (and not H's estate) is treated as the shareholder for purposes of sections 1366, 1367, and 1368, during that 2-year period. After the 2-year period, the S election terminates and the trust continues as a shareholder of a C corporation. If the termination is inadvertent, Corporation Q may request relief under section 1362(f). However, the S election would not terminate if the trustee distributed all Corporation Q shares to L, J, or both on or before October 31, 2005, (the last day of the 2-year period) assuming that neither L nor J becomes the 76th shareholder of Corporation Q as a result of the distribution.

Example 5. QSST when current income beneficiary assigns the income interest to a person not named in the trust. On January 1, 1996, stock of Corporation R, a calendar year S corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. Neither the terms of the trust nor local law preclude the current income beneficiary, K, from assigning K's income interest in the trust. K files a timely QSST election that is effective January 1, 1996. On July 1, 1996, K assigns the income interest in the trust to N. Under applicable state law, the trustee is bound as a result of the assignment to distribute the trust income to N. Thus, the QSST will cease to qualify as a QSST under section 1361(d)(3)(A)(iii) because N's interest will terminate on K's death (rather than on N's death). Accordingly, as of the date of the assignment, the trust ceases to be a QSST and Corporation R ceases to be an S corporation.

Example 6. QSST when terms fail to provide for distribution of trust assets upon termination during life of current income beneficiary. A contributes S corporation stock to a trust the terms of which provide for one income beneficiary, annual distributions of income, discretionary invasion of corpus only for the benefit of the income beneficiary, and termination of the trust only upon the death of the current income beneficiary. Since the trust can terminate only upon the death of the income beneficiary, the governing instrument fails to provide for any distribution of trust assets during the income beneficiary's life. The governing instrument's silence on this point does not disqualify the trust under section 1361(d)(3)(A) (ii) or (iv).

Example 7. QSST when settlor of trust retains a reversion in the trust. On January 10, 1996, M

transfers to a trust shares of stock in corporation X, an S corporation. D, who is 13 years old and not a lineal descendant of M, is the sole income beneficiary of the trust. On termination of the trust, the principal (including the X shares) is to revert to M. The trust instrument provides that the trust will terminate upon the earlier of D's death or D's 21st birthday. The terms of the trust satisfy all of the requirements to be a QSST except those of section 1361(d)(3)(A)(ii) (that corpus may be distributed during the current income beneficiary's life only to that beneficiary) and (iv) (that, upon termination of the trust during the life of the current income beneficiary, the corpus, must be distributed to that beneficiary). On February 10, 1996, M makes a gift of M's reversionary interest to D. Until M assigns M's reversion in the trust to D, M is deemed to own the entire trust under section 673(a) and the trust is a qualified subpart E trust. For purposes of section 1361(b)(1), 1366, 1367, and 1368, M is the shareholder of X. The trust ceases to be a qualified subpart E trust on February 10, 1996. Assuming that, by virtue of the assignment to D of M's reversionary interest, D (upon his 21st birthday) or D's estate (in the case of D's death before reaching age 21) is entitled under local law to receive the trust principal, the trust will be deemed as of February 10, 1996, to have satisfied the conditions of section 1361(d)(3)(A) (ii) and (iv) even though the terms of the trust do not explicitly so provide. D must make a QSST election by no later than April 25, 1996 (the end of the 16-day-and-2-month period that begins on February 10, 1996, the date on which the X stock is deemed transferred to the trust by M). See example (5) of §1.1001–2(c) of the regulations.

Example 8. QSST when the income beneficiary has the power to withdraw corpus. On January 1, 1996, F transfers stock of an S corporation to an irrevocable trust whose income beneficiary is F's son, C. Under the terms of the trust, C is given the noncumulative power to withdraw from the corpus of the trust the greater of $5,000 or 5 percent of the value of the corpus on a yearly basis. The terms of the trust meet the QSST requirements. Assuming the trust distributions are not in satisfaction of F's legal obligation to support C, the trust qualifies as a QSST. C (or if C is a minor, C's legal representative) must make the QSST election no later than March 16, 1996 (the end of the 16-day-and-2-month period that begins on the date the stock is transferred to the trust).

Example 9. (i) *Filing the QSST election.* On January 1, 1996, stock of Corporation T, a calendar year C corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. On January 31, 1996, Corporation T files an election to be an S corporation that is to be effective for its taxable year beginning on January 1, 1996. In order for the S election to be effective for the 1996 taxable year, the QSST election must be effective January 1, 1996, and must be filed within the period beginning on January 1, 1996, and ending March 16, 1996 (the 16-day-and-2-month period beginning on the first day of the first taxable year for which the election to be an S corporation is intended to be effective).

(ii) *QSST election when the S election is filed late.* Assume the same facts as in paragraph (i) of this *Example 9,* except that Corporation T's election to be an S corporation is filed on April 1, 1996 (after the 15th day of the 3rd month of the first taxable year for which it is to be effective but before the end of that taxable year). Because the election to be an S corporation is not timely filed for the 1996 taxable year, under section 1362(b)(3), the S election is treated as made for the taxable year beginning on January 1, 1997. The QSST election must be filed within the 16-day-and-2-month period beginning on April 1, 1996, the date the S election was made, and ending on June 16, 1996.

Example 10. (i) *Transfers to QTIP trust.* On June 1, 1996, A transferred S corporation stock to a trust for the benefit of A's spouse B, the terms of which satisfy the requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, B is the sole income beneficiary for life. In addition, corpus may be distributed to B, at the trustee's discretion, during B's lifetime. However, under section 677(a), A is treated as the owner of the trust. Accordingly, the trust is a permitted shareholder of the S corporation under section 1361(c)(2)(A)(i), and A is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *Transfers to QTIP trust where husband and wife divorce.* Assume the same facts as in paragraph (i) of this *Example 10,* except that A and B divorce on May 2, 1997. Under section 682, A ceases to be treated as the owner of the trust under section 677(a) because A and B are no longer husband and wife. Under section 682, after the divorce, B is the income beneficiary of the trust and corpus of the trust may only be distributed to B. Accordingly, assuming the trust otherwise meets the requirements of section 1361(d)(3), B must make the QSST election within 2 months and 15 days after the date of the divorce.

(iii) *Transfers to QTIP trust where no corpus distribution is permitted.* Assume the same facts as in paragraph (i) of this *Example 10,* except that the terms of the trust do not permit corpus to be distributed to B and require its retention by the trust for distribution to A and B's surviving children after the death of B. Under section 677, A is treated as the owner of the ordinary income portion of the trust, but the trust will be subject to tax on

gross income allocable to corpus. Accordingly, the trust does not qualify as an eligible shareholder of the S corporation because it is neither a qualified subpart E trust nor a QSST.

(2) *Effective date*—(i) *In general*. Paragraph (a) of this section, and paragraphs (c) through (k) of this section (as contained in the 26 CFR edition revised April 1, 2003) apply to taxable years of a corporation beginning after July 21, 1995. For taxable years beginning on or before July 21, 1995, to which paragraph (a) of this section and paragraphs (c) through (k) of this section (as contained in the 26 CFR edition revised April 1, 2003) do not apply, see §18.1361–1 of this chapter (as contained in the 26 CFR edition revised April 1, 1995). However, paragraphs (h)(1)(vi), (h)(3)(i)(F), (h)(3)(ii), and (j)(12) of this section (as contained in the 26 CFR edition revised April 1, 2003) are applicable for taxable years beginning on and after May 14, 2002. Otherwise, paragraphs (b)(1)(ii), (f), (h)(1)(ii), (h)(1)(iv), (h)(3)(i)(B), (h)(3)(i)(D), (h)(3)(ii)(A), (h)(3)(ii)(B), (j)(6)(iii)(C), (j)(6)(iii)(D), (j)(7)(ii), and (k)(1) *Example 2*(ii) fourth and last sentences, *Example 3*, and *Example 4*(iii) of this section apply on and after July 17, 2003. Paragraphs (b)(1)(i), (e)(1), (e)(3), (h)(1)(vii), (h)(3)(i)(G), and the fifth sentence of paragraph (j)(8) are effective on *August 14, 2008*.

(ii) *Transition rules*. Taxpayers may apply paragraph (h)(1)(iv)(B) of this section on and after December 24, 2002, and before July 17, 2003, to treat a trust as a testamentary trust, but not during any period for which a QSST or ESBT election was in effect for the trust. In addition, the Internal Revenue Service will not challenge the treatment of a trust described in paragraph (h)(1)(iv)(B) of this section as a permitted shareholder of an S corporation for periods after August 5, 1997, and before the earlier of July 17, 2003, or the effective date of any QSST or ESBT election for that trust.

(iii) *Exception*. If a QSST has sold or otherwise disposed of all or a portion of its S corporation stock in a tax year that is open for the QSST and the income beneficiary but on or before July 21, 1995, the QSST and the income beneficiary may both treat the transaction as if the beneficiary was the owner of the stock sold or disposed of, and thus recognize any gain or loss, or as if the QSST was the owner of the stock sold or disposed of as described in paragraph (j)(8) of this section. This exception applies only if the QSST and the income beneficiary take consistent reporting positions. The QSST and the income beneficiary must disclose by a statement on their respective returns (or amended returns), that they are taking consistent reporting positions.

(l) *Classes of stock*—(1) *General rule*. A corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in paragraph (l)(4) of this section (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

(2) *Determination of whether stock confers identical rights to distribution and liquidation proceeds*—(i) *In general*. The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and

this paragraph (l). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

(ii) *State law requirements for payment and withholding of income tax.* State laws may require a corporation to pay or withhold state income taxes on behalf of some or all of the corporation's shareholders. Such laws are disregarded in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds, within the meaning of paragraph (l)(1) of this section, provided that, when the constructive distributions resulting from the payment or withholding of taxes by the corporation are taken into account, the outstanding shares confer identical rights to distribution and liquidation proceeds. A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock.

(iii) *Buy-sell and redemption agreements*—(A) *In general.* Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless—

(*1*) A principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l), and

(*2*) The agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.

Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock and, thus, are disregarded in determining whether the outstanding shares of stock confer identical rights. For purposes of this paragraph (l)(2)(iii)(A), a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence. Although an agreement may be disregarded in determining whether shares of stock confer identical distribution and liquidation rights, payments pursuant to the agreement may have income or transfer tax consequences.

(B) *Exception for certain agreements.* Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights. In addition, if stock that is substantially nonvested (within the meaning of § 1.83–3(b)) is treated as outstanding under these regulations, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded. Furthermore, the Commissioner may provide by Revenue Ruling or other published guidance that other types of bona fide agreements to redeem or purchase stock are disregarded.

(C) *Safe harbors for determinations of book value.* A determination of book value will be respected if—

(*1*) The book value is determined in accordance with Generally Accepted Accounting Principles (including permitted optional adjustments); or

(*2*) The book value is used for any substantial nontax purpose.

(iv) *Distributions that take into account varying interests in stock during a taxable year.* A governing provision does not, within the meaning of paragraph (l)(2)(i) of this section, alter the rights to liquidation and distribution proceeds conferred by an S corporation's stock merely because the governing provision provides that, as a result of a change in stock ownership, distributions in a taxable year are to be made on the basis of the shareholders' varying interests in the S corporation's income in the current or immediately preceding taxable year. If distributions

pursuant to the provision are not made within a reasonable time after the close of the taxable year in which the varying interests occur, the distributions may be recharacterized depending on the facts and circumstances, but will not result in a second class of stock.

(v) *Special rule for section 338(h)(10) elections.* If the shareholders of an S corporation sell their stock in a transaction for which an election is made under section 338(h)(10) and § 1.338(h)(10)–1, the receipt of varying amounts per share by the shareholders will not cause the S corporation to have more than one class of stock, provided that the varying amounts are determined in arm's length negotiations with the purchaser.

(vi) *Examples.* The application of paragraph (l)(2) of this section may be illustrated by the following examples. In each of the examples, the S corporation requirements of section 1361 are satisfied except as otherwise stated, the corporation has in effect an S election under section 1362, and the corporation has only the shareholders described.

Example 1. Determination of whether stock confers identical rights to distribution and liquidation proceeds. (i) The law of State A requires that permission be obtained from the State Commissioner of Corporations before stock may be issued by a corporation. The Commissioner grants permission to S, a corporation, to issue its stock subject to the restriction that any person who is issued stock in exchange for property, and not cash, must waive all rights to receive distributions until the shareholders who contributed cash for stock have received distributions in the amount of their cash contributions.

(ii) The condition imposed by the Commissioner pursuant to state law alters the rights to distribution and liquidation proceeds conferred by the outstanding stock of S so that those rights are not identical. Accordingly, under paragraph (l)(2)(i) of this section, S is treated as having more than one class of stock and does not qualify as a small business corporation.

Example 2. Distributions that differ in timing. (i) S, a corporation, has two equal shareholders, A and B. Under S's bylaws, A and B are entitled to equal distributions. S distributes $50,000 to A in the current year, but does not distribute $50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds.

(ii) Under paragraph (l)(2)(i) of this section, the difference in timing of the distributions to A and B does not cause S to be treated as having more than one class of stock. However, section 7872 or other recharacterization principles may apply to determine the appropriate tax consequences.

Example 3. Treatment of excessive compensation. (i) S, a corporation, has two equal shareholders, C and D, who are each employed by S and have binding employment agreements with S. The compensation paid by S to C under C's employment agreement is reasonable. The compensation paid by S to D under D's employment agreement, however, is found to be excessive. The facts and circumstances do not reflect that a principal purpose to D's employment agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the employment agreements are not governing provisions. Accordingly, S is not treated as having more than one class of stock by reason of the employment agreements, even though S is not allowed a deduction for the excessive compensation paid to D.

Example 4. Agreement to pay fringe benefits. (i) S, a corporation, is required under binding agreements to pay accident and health insurance premiums on behalf of certain of its employees who are also shareholders. Different premium amounts are paid by S for each employee-shareholder. The facts and circumstances do not reflect that a principal purpose of the agreements is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the agreements are not governing provisions. Accordingly, S is not treated as having more than one class of stock by reason of the agreements. In addition, S is not treated as having more than one class of stock by reason of the payment of fringe benefits.

Example 5. Below-market corporation-shareholder loan. (i) E is a shareholder of S, a corporation. S makes a below-market loan to E that is a corporation-shareholder loan to which section 7872 applies. Under section 7872, E is deemed to receive a distribution with respect to S stock by reason of the loan. The facts and circumstances do not reflect that a principal purpose of the loan is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the loan agreement is not a governing provision. Accordingly, S is not treated as having more than one class of stock by reason of the below-market loan to E.

Example 6. Agreement to adjust distributions for state tax burdens. (i) S, a corporation, executes a binding agreement with its shareholders to modify its normal distribution policy by making upward adjustments of its distributions to those shareholders who bear heavier state tax burdens. The adjustments are based on a formula that will give the shareholders equal after-tax distributions.

(ii) The binding agreement relates to distribution or liquidation proceeds. The agreement is thus a governing provision that alters the rights conferred by the outstanding stock of S to distribution proceeds so that those rights are not identical. Therefore, under paragraph (l)(2)(i) of this section, S is treated as having more than one class of stock.

Example 7. State law requirements for payment and withholding of income tax. (i) The law of State X requires corporations to pay state income taxes on behalf of nonresident shareholders. The law of State X does not require corporations to pay state income taxes on behalf of resident shareholders. S is incorporated in State X. S's resident shareholders have the right (for example, under the law of State X or pursuant to S's bylaws or a binding agreement) to distributions that take into account the payments S makes on behalf of its nonresident shareholders.

(ii) The payment by S of state income taxes on behalf of its nonresident shareholders are generally treated as constructive distributions to those shareholders. Because S's resident shareholders have the right to equal distributions, taking into account the constructive distributions to the nonresident shareholders, S's shares confer identical rights to distribution proceeds. Accordingly, under paragraph (l)(2)(ii) of this section, the state law requiring S to pay state income taxes on behalf of its nonresident shareholders is disregarded in determining whether S has more than one class of stock.

(iii) The same result would follow if the payments of state income taxes on behalf of nonresident shareholders are instead treated as advances to those shareholders and the governing provisions require the advances to be repaid or offset by reductions in distributions to those shareholders.

Example 8. Redemption agreements. (i) F, G, and H are shareholders of S, a corporation. F is also an employee of S. By agreement, S is to redeem F's shares on the termination of F's employment.

(ii) On these facts, under paragraph (l)(2)(iii)(B) of this section, the agreement is disregarded in determining whether all outstanding shares of S's stock confer identical rights to distribution and liquidation proceeds.

Example 9. Analysis of redemption agreements. (i) J, K, and L are shareholders of S, a corporation. L is also an employee of S. L's shares were not issued to L in connection with the performance of services. By agreement, S is to redeem L's shares for an amount significantly below their fair market value on the termination of L's employment or if S's sales fall below certain levels.

(ii) Under paragraph (l)(2)(iii)(B) of this section, the portion of the agreement providing for redemption of L's stock on termination of employment is disregarded. Under paragraph (l)(2)(iii)(A), the portion of the agreement providing for redemption of L's stock if S's sales fall below certain levels is disregarded unless a principal purpose of that portion of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(3) *Stock taken into account.* Except as provided in paragraphs (b) (3), (4), and (5) of this section (relating to restricted stock, deferred compensation plans, and straight debt), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account. For example, substantially nonvested stock with respect to which an election under section 83(b) has been made is taken into account in determining whether a corporation has a second class of stock, and such stock is not treated as a second class of stock if the stock confers rights to distribution and liquidation proceeds that are identical, within the meaning of paragraph (l)(1) of this section, to the rights conferred by the other outstanding shares of stock.

(4) *Other instruments, obligations, or arrangements treated as a second class of stock*—(i) *In general.* Instruments, obligations, or arrangements are not treated as a second class of stock for purposes of this paragraph (l) unless they are described in paragraph (l)(5) (ii) or (iii) of this section. However, in no event are instruments, obligations, or arrangements described in paragraph (b)(4) of this section (relating to deferred compensation plans), paragraphs (l)(4)(iii) (B) and (C) of this section (relating to the exceptions and safe harbor for options), paragraph (l)(4)(ii)(B) of this section (relating to the safe harbors for certain short-term unwritten advances and proportionally-held debt), or paragraph (l)(5) of this section (relating to the safe harbor for straight debt), treated as a second class of stock for purposes of this paragraph (l).

(ii) *Instruments, obligations, or arrangements treated as equity under general principles*—(A) *In general*. Except as provided in paragraph (l)(4)(i) of this section, any instrument, obligation, or arrangement issued by a corporation (other than outstanding shares of stock described in paragraph (l)(3) of this section), regardless of whether designated as debt, is treated as a second class of stock of the corporation—

(*1*) If the instrument, obligation, or arrangement constituters equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law; and

(*2*) A principal purpose of issuing or entering into the instrument, obligation, or arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders contained in paragraph (b)(1) of this section.

(B) *Safe harbor for certain short-term unwritten advances and proportionately held obligations*—(*1*) *Short-term unwritten advances*. Unwritten advances from a shareholder that do not exceed $10,000 in the aggregate at any time during the taxable year of the corporation, are treated as debt by the parties, and are expected to be repaid within a reasonable time are not treated as a second class of stock for that taxable year, even if the advances are considered equity under general principles of Federal tax law. The failure of an unwritten advance to meet this safe harbor will not result in a second class of stock unless the advance is considered equity under paragraph (l)(4)(ii)(A)(*1*) of this section and a principal purpose of the advance is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders under paragraph (l)(4)(ii)(A)(*2*) of this section.

(*2*) *Proportionately-held obligations*. Obligations of the same class that are considered equity under general principles of Federal tax law, but are owned solely by the owners of, and in the same proportion as, the outstanding stock of the corporation, are not treated as a second class of stock. Furthermore, an obligation or obligations owned by the sole shareholder of a corporation are always held proportionately to the corporation's outstanding stock. The obligations that are considered equity that do not meet this safe harbor will not result in a second class of stock unless a principal purpose of the obligations is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders under paragraph (l)(4)(ii)(A)(*2*) of this section.

(iii) *Certain call options, warrants or similar instruments*—(A) *In general*. Except as otherwise provided in this paragraph (l)(4)(iii), a call option, warrant, or similar instrument (collectively, call option) issued by a corporation is treated as a second class of stock of the corporation if, taking into account all the facts and circumstances, the call option is substantially certain to be exercised (by the holder or a potential transferee) and has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued, transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section, or materially modified. For purposes of this paragraph (l)(4)(iii), if an option is issued in connection with a loan and the time period in which the option can be exercised is extended in connection with (and consistent with) a modification of the terms of the loan, the extension of the time period in which the option may be exercised is not considered a material modification. In addition, a call option does not have a strike price substantially below fair market value if the price at the time of exercise cannot, pursuant to the terms of the instrument, be substantially below the fair market value of the underlying stock at the time of exercise.

(B) *Certain exceptions*. (*1*) A call option is not treated as a second class of stock for purposes of this paragraph (l) if it is issued to a person that is actively and regularly engaged in the business of lending and issued in connection with a commercially reasonable loan to the corporation. This paragraph (l)(4)(iii)(B)(*1*) continues to apply if the call option is transferred with

the loan (or if a portion of the call option is transferred with a corresponding portion of the loan). However, if the call option is transferred without a corresponding portion of the loan, this paragraph (l)(4)(iii)(B)(*1*) ceases to apply. Upon that transfer, the call option is tested under paragraph (l)(4)(iii)(A) (notwithstanding anything in that paragraph to the contrary) if, but for this paragraph, the call option would have been treated as a second class of stock on the date it was issued.

(*2*) A call option that is issued to an individual who is either an employee or an independent contractor in connection with the performance of services for the corporation or a related corporation (and that is not excessive by reference to the services performed) is not treated as a second class of stock for purposes of this paragraph (l) if—

(*i*) The call option is nontransferable within the meaning of § 1.83–3(d); and

(*ii*) The call option does not have a readily ascertainable fair market value as defined in § 1.83–7(b) at the time the option is issued.

If the call option becomes transferable, this paragraph (l)(4)(iii)(B)(*2*) ceases to apply. Solely for purposes of this paragraph (l)(4)(iii)(B)(*2*), a corporation is related to the issuing corporation if more than 50 percent of the total voting power and total value of its stock is owned by the issuing corporation.

(*3*) The Commissioner may provide other exceptions by Revenue Ruling or other published guidance.

(C) *Safe harbor for certain options.* A call option is not treated as a second class of stock if, on the date the call option is issued, transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section, or materially modified, the strike price of the call option is at least 90 percent of the fair market value of the underlying stock on that date. For purposes of this paragraph (l)(4)(iii)(C), a good faith determination of fair market value by the corporation will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence to obtain a fair value. Failure of an option to meet this safe harbor will not necessarily result in the option being treated as a second class of stock.

(iv) *Convertible debt.* A convertible debt instrument is considered a second class of stock if—

(A) It would be treated as a second class of stock under paragraph (l)(4)(ii) of this section (relating to instruments, obligations, or arrangements treated as equity under general principles); or

(B) It embodies rights equivalent to those of a call option that would be treated as a second class of stock under paragraph (l)(4)(iii) of this section (relating to certain call options, warrants, and similar instruments).

(v) *Examples.* The application of this paragraph (l)(4) may be illustrated by the following examples. In each of the examples, the S corporation requirements of section 1361 are satisfied except as otherwise stated, the corporation has in effect an S election under section 1362, and the corporation has only the shareholders described.

Example 1. Transfer of call option by eligible shareholder to ineligible shareholder. (i) S, a corporation, has 10 shareholders. S issues call options to A, B, and C, individuals who are U.S. residents. A, B, and C are not shareholders, employees, or independent contractors of S. The options have a strike price of $40 and are issued on a date when the fair market value of S stock is also $40. A year later, P, a partnership, purchases A's option. On the date of transfer, the fair market value of S stock is $80.

(ii) On the date the call option is issued, its strike price is not substantially below the fair market value of the S stock. Under paragraph (l)(4)(iii)(A) of this section, whether a call option is a second class of stock must be redetermined if the call option is transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section. In this case, A is an eligible shareholder of S under paragraph (b)(1) of this section, but P is not. Accordingly, the option is retested on the date it is transferred to D.

(iii) Because on the date the call option is transferred to P its strike price is 50% of the fair market value, the strike price is substantially below the fair market value of the S stock. Accordingly, the call option is treated as a second class of stock as of the date it is transferred to P if, at that time, it

is determined that the option is substantially certain to be exercised. The determination of whether the option is substantially certain to be exercised is made on the basis of all the facts and circumstances.

Example 2. Call option issued in connection with the performance of services. (i) E is a bona fide employee of S, a corporation. S issues to E a call option in connection with E's performance of services. At the time the call option is issued, it is not transferable and does not have a readily ascertainable fair market value. However, the call option becomes transferable before it is exercised by E.

(ii) While the option is not transferable, under paragraph (l)(4)(iii)(B)(*2*) of this section, it is not treated as a second class of stock, regardless of its strike price. When the option becomes transferable, that paragraph ceases to apply, and the general rule of paragraph (l)(4)(iii)(A) of this section applies. Accordingly, if the option is materially modified or is transferred to a person who is not an eligible shareholder under paragraph (b)(1) of this section, and on the date of such modification or transfer, the option is substantially certain to be exercised and has a strike price substantially below the fair market value of the underlying stock, the option is treated as a second class of stock.

(iii) If E left S's employment before the option became transferable, the exception provided by paragraph (l)(4)(iii)(B)(*2*) would continue to apply until the option became transferable.

(5) *Straight debt safe harbor*—(i) *In general.* Notwithstanding paragraph (l)(4) of this section, straight debt is not treated as a second class of stock. For purposes of section 1361(c)(5) and this section, the term straight debt means a written unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand, or on a specified due date, which—

(A) Does not provide for an interest rate or payment dates that are contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors;

(B) Is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation; and

(C) Is held by an individual (other than a nonresident alien), an estate, or a trust described in section 1361(c)(2).

(ii) *Subordination.* The fact that an obligation is subordinated to other debt of the corporation does not prevent the obligation from qualifying as straight debt.

(iii) *Modification or transfer.* An obligation that originally qualifies as straight debt ceases to so qualify if the obligation—

(A) Is materially modified so that it no longer satisfies the definition of straight debt; or

(B) Is transferred to a third party who is not an eligible shareholder under paragraph (b)(1) of this section.

(iv) *Treatment of straight debt for other purposes.* An obligation of an S corporation that satisfies the definition of straight debt in paragraph (l)(5)(i) of this section is not treated as a second class of stock even if it is considered equity under general principles of Federal tax law. Such an obligation is generally treated as debt and when so treated is subject to the applicable rules governing indebtedness for other purposes of the Code. Accordingly, interest paid or accrued with respect to a straight debt obligation is generally treated as interest by the corporation and the recipient and does not constitute a distribution to which section 1368 applies. However, if a straight debt obligation bears a rate of interest that is unreasonably high, an appropriate portion of the interest may be recharacterized and treated as a payment that is not interest. Such a recharacterization does not result in a second class of stock.

(v) *Treatment of C corporation debt upon conversion to S status.* If a C corporation has outstanding an obligation that satisfies the definition of straight debt in paragraph (l)(5)(i) of this section, but that is considered equity under general principles of Federal tax law, the obligation is not treated as a second class of stock for purposes of this section if the C corporation converts to S status. In addition, the conversion from C corporation status to S corporation status is not treated as an exchange of debt for stock with respect to such an instrument.

(6) *Inadvertent terminations.* See section 1362(f) and the regulations thereunder for rules relating to inadvertent terminations in cases where the one class of stock requirement has been inadvertently breached.

(7) *Effective date.* Section 1.1361–1(l) generally applies to taxable years of a corporation beginning on or after May

28, 1992. However, § 1.1361–1(l) does not apply to: an instrument, obligation, or arrangement issued or entered into before May 28, 1992, and not materially modified after that date; a buy-sell agreement, redemption agreement, or agreement restricting transferability entered into before May 28, 1992, and not materially modified after that date; or a call option or similar instrument issued before May 28, 1992, and not materially modified after that date. In addition, a corporation and its shareholders may apply this § 1.1361–1(l) to prior taxable years.

(m) *Electing small business trust (ESBT)*—(1) *Definition*—(i) *General rule.* An electing small business trust (ESBT) means any trust if it meets the following requirements: the trust does not have as a beneficiary any person other than an individual, an estate, an organization described in section 170(c)(2) through (5), or an organization described in section 170(c)(1) that holds a contingent interest in such trust and is not a potential current beneficiary; no interest in the trust has been acquired by purchase; and the trustee of the trust makes a timely ESBT election for the trust.

(ii) *Qualified beneficiaries*—(A) *In general.* For purposes of this section, a beneficiary includes a person who has a present, remainder, or reversionary interest in the trust.

(B) *Distributee trusts.* A distributee trust is the beneficiary of the ESBT only if the distributee trust is an organization described in section 170(c)(2) or (3). In all other situations, any person who has a beneficial interest in a distributee trust is a beneficiary of the ESBT. A distributee trust is a trust that receives or may receive a distribution from an ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.

(C) *Powers of appointment.* A person in whose favor a power of appointment could be exercised is not a beneficiary of an ESBT until the holder of the power of appointment actually exercises the power in favor of such person.

(D) *Nonresident aliens.* A nonresident alien (NRA), as defined in section 7701(b)(1)(B), is an eligible beneficiary of an ESBT and an eligible potential current beneficiary.

(iii) *Interests acquired by purchase.* A trust does not qualify as an ESBT if any interest in the trust has been acquired by purchase. Generally, if a person acquires an interest in the trust and thereby becomes a beneficiary of the trust as defined in paragraph (m)(1)(ii)(A), and any portion of the basis in the acquired interest in the trust is determined under section 1012, such interest has been acquired by purchase. This includes a net gift of a beneficial interest in the trust, in which the person acquiring the beneficial interest pays the gift tax. The trust itself may acquire S corporation stock or other property by purchase or in a part-gift, part-sale transaction.

(iv) *Ineligible trusts.* An ESBT does not include—

(A) Any qualified subchapter S trust (as defined in section 1361(d)(3)) if an election under section 1361(d)(2) applies with respect to any corporation the stock of which is held by the trust;

(B) Any trust exempt from tax or not subject to tax under subtitle A; or

(C) Any charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)).

(2) *ESBT election*—(i) *In general.* The trustee of the trust must make the ESBT election by signing and filing, with the service center where the S corporation files its income tax return, a statement that meets the requirements of paragraph (m)(2)(ii) of this section. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must sign the election statement. If any one of several trustees can legally bind the trust, only one trustee needs to sign the election statement. Generally, only one ESBT election is made for the trust, regardless of the number of S corporations whose stock is held by the ESBT. However, if the ESBT holds stock in multiple S corporations that file in different service centers, the ESBT election must be filed with all the relevant service centers where the corporations file their income tax returns. This requirement applies only at the time of the initial ESBT election; if the ESBT later acquires stock in an S corporation which files its income tax return at a different service

center, a new ESBT election is not required.

(ii) *Election statement*. The election statement must include—

(A) The name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the S corporations in which the trust currently holds stock. If the trust includes a power described in paragraph (m)(4)(vi)(B) of this section, then the election statement must include a statement that such a power is included in the instrument, but does not need to include the name, address, or taxpayer identification number of any particular charity or any other information regarding the power.

(B) An identification of the election as an ESBT election made under section 1361(e)(3);

(C) The first date on which the trust owned stock in each S corporation;

(D) The date on which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed); and

(E) Representations signed by the trustee stating that—

(*1*) The trust meets the definitional requirements of section 1361(e)(1); and

(*2*) All potential current beneficiaries of the trust meet the shareholder requirements of section 1361(b)(1); for the purpose of this paragraph (m)(2)(ii)(E)(*2*), an NRA potential current beneficiary does not violate the requirement under section 1361(b)(1)(C) that an S corporation cannot have an NRA as a shareholder.

(iii) *Due date for ESBT election*. The ESBT election must be filed within the time requirements prescribed in paragraph (j)(6)(iii) of this section for filing a qualified subchapter S trust (QSST) election.

(iv) *Election by a trust described in section 1361(c)(2)(A)(ii) or (iii)*. A trust that is a qualified S corporation shareholder under section 1361(c)(2)(A)(ii) or (iii) may elect ESBT treatment at any time during the 2-year period described in those sections or the 16-day-and-2-month period beginning on the date after the end of the 2-year period. If the trust makes an ineffective ESBT election, the trust will continue nevertheless to qualify as an eligible S corporation shareholder for the remainder of the period described in section 1361(c)(2)(A)(ii) or (iii).

(v) *No protective election*. A trust cannot make a conditional ESBT election that would be effective only in the event the trust fails to meet the requirements for an eligible trust described in section 1361(c)(2)(A)(i) through (iv). If a trust attempts to make such a conditional ESBT election and it fails to qualify as an eligible S corporation shareholder under section 1361(c)(2)(A)(i) through (iv), the S corporation election will be ineffective or will terminate because the corporation will have an ineligible shareholder. Relief may be available under section 1362(f) for an inadvertent ineffective S corporation election or an inadvertent S corporation election termination. In addition, a trust that qualifies as an ESBT may make an ESBT election notwithstanding that the trust is a wholly-owned grantor trust.

(3) *Effect of ESBT election*—(i) *General rule*. If a trust makes a valid ESBT election, the trust will be treated as an ESBT for purposes of chapter 1 of the Internal Revenue Code as of the effective date of the ESBT election.

(ii) *Employer Identification Number*. An ESBT has only one employer identification number (EIN). If an existing trust makes an ESBT election, the trust continues to use the EIN it currently uses.

(iii) *Taxable year*. If an ESBT election is effective on a day other than the first day of the trust's taxable year, the ESBT election does not cause the trust's taxable year to close. The termination of the ESBT election (including a termination caused by a conversion of the ESBT to a QSST) other than on the last day of the trust's taxable year also does not cause the trust's taxable year to close. In either case, the trust files one tax return for the taxable year.

(iv) *Allocation of S corporation items*. If, during the taxable year of an S corporation, a trust is an ESBT for part of the year and an eligible shareholder under section 1361(c)(2)(A)(i) through (iv) for the rest of the year, the S corporation items are allocated between the two types of trusts under section 1377(a). See § 1.1377–1(a)(2)(iii).

(v) *Estimated taxes.* If an ESBT election is effective on a day other than the first day of the trust's taxable year, the trust is considered one trust for purposes of estimated taxes under section 6654.

(4) *Potential current beneficiaries*—(i) *In general.* For purposes of determining whether a corporation is a small business corporation within the meaning of section 1361(b)(1), each potential current beneficiary of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of this paragraph (m)(4), a potential current beneficiary generally is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust. A person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust. No person is treated as a potential current beneficiary solely because that person holds any future interest in the trust. An NRA potential current beneficiary of an ESBT is treated as a shareholder for purposes of the 100-shareholder limit under section 1361(b)(1)(A). However, an NRA potential current beneficiary of an ESBT is not treated as a shareholder in determining whether a corporation is a small business corporation for purposes of the NRA-shareholder prohibition under section 1361(b)(1)(C).

(ii) *Grantor trusts.* If all or a portion of an ESBT is treated as owned by a person under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code, such owner is a potential current beneficiary in addition to persons described in paragraph (m)(4)(i) of this section.

(iii) *Special rule for dispositions of stock.* Notwithstanding the provisions of paragraph (m)(4)(i) of this section, if a trust disposes of all of the stock which it holds in an S corporation, then, with respect to that corporation, any person who first met the definition of a potential current beneficiary during the 1-year period ending on the date of such disposition is not a potential current beneficiary and thus is not a shareholder of that corporation.

(iv) *Distributee trusts*—(A) *In general.* This paragraph (m)(4)(iv) contains the rules for determining who are the potential current beneficiaries of an ESBT if a distributee trust becomes entitled to, or at the discretion of any person, may receive a distribution from principal or income of an ESBT. A distributee trust does not include a trust that is not currently in existence. For this purpose, a trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit. Thus, if a trust instrument provides for a trust to be funded at some future time, the future trust is not currently a distributee trust.

(B) If the distributee trust is not a trust described in section 1361(c)(2)(A), then the distributee trust is the potential current beneficiary of the ESBT and the corporation's S corporation election terminates.

(C) If the distributee trust is a trust described in section 1361(c)(2)(A), the persons who would be its potential current beneficiaries (as defined in paragraphs (m)(4)(i) and (ii) of this section) if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT. Notwithstanding the preceding sentence, however, if the distributee trust is a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate described in section 1361(c)(2)(B) (ii) or (iii) is treated as the potential current beneficiary of the ESBT for the 2-year period during which such trust would be permitted as a shareholder.

(D) For the purposes of paragraph (m)(4)(iv)(C) of this section, a trust will be deemed to be described in section 1361(c)(2)(A) if such trust would qualify for a QSST election under section 1361(d) or an ESBT election under section 1361(e) if it owned S corporation stock.

(v) *Contingent distributions.* A person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of a power of appointment) is not a potential current beneficiary until such time or the occurrence of such event.

(vi) *Currently exercisable powers of appointment and other powers*—(A) *Powers of appointment.* A person to whom a distribution may be made during any period pursuant to a power of appointment (as described for transfer tax purposes in section 2041 and § 20.2041–1(b) of this chapter and section 2514 and § 25.2514–1(b) of this chapter) is not a potential current beneficiary unless the power is exercised in favor of that person during the period. It is immaterial for purposes of this paragraph (m)(4)(vi)(A) whether such power of appointment is a ''general power of appointment'' for transfer tax purposes as described in §§ 20.2041–1(c) and 25.2514–1(c) of this chapter. The mere existence of one or more powers of appointment during the lifetime of a power holder that would permit current distributions from the trust to be made to more than the number of persons described in section 1361(b)(1)(A) or to a person described in section 1361(b)(1)(B) or (C) will not cause the S corporation election to terminate unless one or more of such powers are exercised, collectively, in favor of an excessive number of persons or in favor of a person who is ineligible to be an S corporation shareholder. For purposes of this paragraph (m)(4)(vi)(A), a ''power of appointment'' includes a power, regardless of by whom held, to add a beneficiary or class of beneficiaries to the class of potential current beneficiaries, but generally does not include a power held by a fiduciary who is not also a beneficiary of the trust to spray or sprinkle trust distributions among beneficiaries. Nothing in this paragraph (m)(4)(vi)(A) alters the definition of ''power of appointment'' for purposes of any provision of the Internal Revenue Code or the regulations.

(B) *Powers to distribute to certain organizations not pursuant to powers of appointment.* If a trustee or other fiduciary has a power (that does not constitute a power of appointment for transfer tax purposes as described in §§ 20.2041–1(b) and 25.2514–1(b) of this chapter) to make distributions from the trust to one or more members of a class of organizations described in section 1361(c)(6), such organizations will be counted collectively as only one potential current beneficiary for purposes of this paragraph (m), except that each organization receiving a distribution also will be counted as a potential current beneficiary. This paragraph (m)(4)(vi)(B) shall not apply to a power to currently distribute to one or more particular charitable organizations described in section 1361(c)(6). Each of such organizations is a potential current beneficiary of the trust.

(vii) *Number of shareholders.* Each potential current beneficiary of the ESBT, as defined in paragraphs (m)(4)(i) through (vi) of this section, is counted as a shareholder of any S corporation whose stock is owned by the ESBT. During any period in which the ESBT has no potential current beneficiaries, the ESBT is counted as the shareholder. A person is counted as only one shareholder of an S corporation even though that person may be treated as a shareholder of the S corporation by direct ownership and through one or more eligible trusts described in section 1361(c)(2)(A). Thus, for example, if a person owns stock in an S corporation and is a potential current beneficiary of an ESBT that owns stock in the same S corporation, that person is counted as one shareholder of the S corporation. Similarly, if a husband owns stock in an S corporation and his wife is a potential current beneficiary of an ESBT that owns stock in the same S corporation, the husband and wife will be counted as one shareholder of the S corporation.

(viii) *Miscellaneous.* Payments made by an ESBT to a third party on behalf of a beneficiary are considered to be payments made directly to the beneficiary. The right of a beneficiary to assign the beneficiary's interest to a third party does not result in the third party being a potential current beneficiary until that interest is actually assigned.

(5) *ESBT terminations*—(i) *Ceasing to meet ESBT requirements.* A trust ceases to be an ESBT on the first day the trust fails to meet the definition of an ESBT under section 1361(e). The last day the trust is treated as an ESBT is the day before the date on which the trust fails to meet the definition of an ESBT.

(ii) *Disposition of S stock*. In general, a trust ceases to be an ESBT on the first day following the day the trust disposes of all S corporation stock. However, if the trust is using the installment method to report income from the sale or disposition of its stock in an S corporation, the trust ceases to be an ESBT on the day following the earlier of the day the last installment payment is received by the trust or the day the trust disposes of the installment obligation.

(iii) *Potential current beneficiaries that are ineligible shareholders*. If a potential current beneficiary of an ESBT is not an eligible shareholder of a small business corporation within the meaning of section 1361(b)(1), the S corporation election terminates. For example, the S corporation election will terminate if a charitable remainder trust becomes a potential current beneficiary of an ESBT. Such a potential current beneficiary is treated as an ineligible shareholder beginning on the day such person becomes a potential current beneficiary, and the S corporation election terminates on that date. However, *see* the special rule of paragraph (m)(4)(iii) of this section. If the S corporation election terminates, relief may be available under section 1362(f).

(6) *Revocation of ESBT election*. An ESBT election may be revoked only with the consent of the Commissioner. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request under the appropriate revenue procedure.

(7) *Converting an ESBT to a QSST*. For a trust that seeks to convert from an ESBT to a QSST, the consent of the Commissioner is hereby granted to revoke the ESBT election as of the effective date of the QSST election, if all the following requirements are met:

(i) The trust meets all of the requirements to be a QSST under section 1361(d).

(ii) The trustee and the current income beneficiary of the trust sign the QSST election. The QSST election must be filed with the service center where the S corporation files its income tax return. This QSST election must state at the top of the document ''ATTENTION ENTITY CONTROL—CONVERSION OF AN ESBT TO A QSST PURSUANT TO SECTION 1.1361–1(m)'' and include all information otherwise required for a QSST election under §1.1361–1(j)(6). A separate QSST election must be made with respect to the stock of each S corporation held by the trust.

(iii) The trust has not converted from a QSST to an ESBT within the 36-month period preceding the effective date of the new QSST election.

(iv) The date on which the QSST election is to be effective cannot be more than 15 days and two months prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 15 days and two months prior to the date on which the election is filed, it will be effective on the day that is 15 days and two months prior to the date on which it is filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective on the day that is 12 months after the date it is filed.

(8) *Examples*. The provisions of this paragraph (m) are illustrated by the following examples in which it is assumed, unless otherwise specified, that all noncorporate persons are citizens or residents of the United States:

(i) *Example 1*—(A) *ESBT election with section 663(c) separate shares*. On January 1, 2003, *M* contributes S corporation stock to Trust for the benefit of *M*'s three children *A*, *B*, and *C*. Pursuant to section 663(c), each of Trust's separate shares for *A*, *B*, and *C* will be treated as separate trusts for purposes of determining the amount of distributable net income (DNI) in the application of sections 661 and 662. On January 15, 2003, the trustee of Trust files a valid ESBT election for Trust effective January 1, 2003. Trust will be treated as a single ESBT and will have a single S portion taxable under section 641(c).

(B) *ESBT acquires stock of an additional S corporation*. On February 15, 2003, Trust acquires stock of an additional S corporation. Because Trust is already an ESBT, Trust does not need to make an additional ESBT election.

(C) *Section 663(c) shares of ESBT convert to separate QSSTs.* Effective January 1, 2004, *A*, *B*, *C*, and Trust's trustee elect to convert each separate share of Trust into a separate QSST pursuant to paragraph (m)(7) of this section. For each separate share, they file a separate election for each S corporation whose stock is held by Trust. Each separate share will be treated as a separate QSST.

(ii) *Example 2*—(A) *Invalid potential current beneficiary.* Effective January 1, 2005, Trust makes a valid ESBT election. On January 1, 2006, A, a partnership, becomes a potential current beneficiary of Trust. Trust does not dispose of all of its S corporation stock within one year after January 1, 2006. As of January 1, 2006, *A* is the potential current beneficiary of Trust and therefore is treated as a shareholder of the S corporation. Because *A* is not an eligible shareholder of an S corporation under section 1361(b)(1), the S corporation election of any corporation in which Trust holds stock terminates effective January 1, 2006. Relief may be available under section 1362(f).

(B) *Invalid potential current beneficiary and disposition of S stock.* Assume the same facts as in *Example 2* in paragraph (m)(8)(ii)(A) of this section except that within one year after January 1, 2006, trustee of Trust disposes of all Trust's S corporation stock. *A* is not considered a potential current beneficiary of Trust and therefore is not treated as a shareholder of any S corporation in which Trust previously held stock.

(iii) *Example 3. Subpart E trust. M* transfers stock in *X*, an S corporation, and other assets to Trust for the benefit of *B* and *B*'s siblings. *M* retains no powers or interest in Trust. Under section 678(a), *B* is treated as the owner of a portion of Trust that includes a portion of the *X* stock. No beneficiary has acquired any portion of his or her interest in Trust by purchase, and Trust is not an ineligible trust under paragraph (m)(1)(iv) of this section. Trust is eligible to make an ESBT election.

(iv) *Example 4. Subpart E trust continuing after grantor's death.* On January 1, 2003, M transfers stock in *X*, an S corporation, and other assets to Trust. Under the terms of Trust, the trustee of Trust has complete discretion to distribute the income or principal to *M* during *M*'s lifetime and to *M*'s children upon *M*'s death. During *M*'s life, *M* is treated as the owner of Trust under section 677. The trustee of Trust makes a valid election to treat Trust as an ESBT effective January 1, 2003. On March 28, 2004, M dies. Under applicable local law, Trust does not terminate on *M*'s death. Trust continues to be an ESBT after *M*'s death, and no additional ESBT election needs to be filed for Trust after *M*'s death.

(v) *Example 5. Potential current beneficiaries and distributee trust holding S corporation stock.* Trust-1 has a valid ESBT election in effect. The trustee of Trust-1 has the power to make distributions to *A* directly or to any trust created for the benefit of *A*. On January 1, 2003, *M* creates Trust-2 for the benefit of *A*. Also on January 1, 2003, the trustee of Trust-1 distributes some S corporation stock to Trust-2. *A*, as the current income beneficiary of Trust-2, makes a timely and effective election to treat Trust-2 as a QSST. Because Trust-2 is a valid S corporation shareholder, the distribution to Trust-2 does not terminate the ESBT election of Trust-1. Trust-2 itself will not be counted toward the shareholder limit of section 1361(b)(1)(A). Additionally, because *A* is already counted as an S corporation shareholder because of *A*'s status as a potential current income beneficiary of Trust-1, *A* is not counted again by reason of *A*'s status as the deemed owner of Trust-2.

(vi) *Example 6. Potential current beneficiaries and distributee trust not holding S corporation stock*—(A) *Distributee trust that would itself qualify as an ESBT.* Trust-1 holds stock in *X*, an S corporation, and has a valid ESBT election in effect. Under the terms of Trust-1, the trustee has discretion to make distributions to *A*, *B*, and Trust-2, a trust for the benefit of *C*, *D*, and *E*. Trust-2 would qualify to be an ESBT, but it owns no S corporation stock and has made no ESBT election. Under paragraph (m)(4)(iv) of this section, Trust-2's potential current beneficiaries are treated as the potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Thus, *A*, *B*, *C*, *D*, and *E* are potential current beneficiaries of

Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Trust-2 itself will not be counted as a shareholder of Trust-1 for purposes of section 1361(b)(1).

(B) *Distributee trust that would not qualify as an ESBT or a QSST.* Assume the same facts as *Example 6* in paragraph (m)(8)(vi)(A) of this section except that D is a charitable remainder trust. Trust-2 would not be eligible to make an ESBT or QSST election if it owned S corporation stock and therefore Trust-2 is a potential current beneficiary of Trust-1. Since Trust-2 is not an eligible shareholder, *X*'s S corporation election terminates.

(C) *Distributee trust that is a section 1361(c)(2)(A)(ii) trust.* Assume the same facts as in *Example 6* in paragraph (m)(8)(vi)(A) of this section except that Trust-2 is a trust treated as owned by *A* under section 676 because *A* has the power to revoke Trust-2 at any time prior to *A*'s death. On January 1, 2003, *A* dies. Because Trust-2 is a trust described in section 1361(c)(2)(A)(ii) during the 2-year period beginning on the day of *A*'s death, under paragraph (m)(4)(iv)(C) of this section, Trust-2's only potential current beneficiary is the person listed in section 1361(c)(2)(B)(ii), *A*'s estate. Thus, *B* and *A*'s estate are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1).

(vii) *Example 7. Potential current beneficiaries and powers of appointment. M* creates Trust from which *A* has a right to all net income and funds it with S corporation stock. *A* also has a currently exercisable power to appoint income or principal to anyone except *A*, *A*'s creditors, *A*'s estate, and the creditors of A's estate. The potential current beneficiaries of Trust for any period will be *A* and each person who receives a distribution from Trust pursuant to *A*'s exercise of *A*'s power of appointment during that period.

(viii) *Example 8. Power to distribute to an unlimited class of charitable organizations not pursuant to a power of appointment. M* creates Trust from which *A* has a right to all net income and funds it with S corporation stock. In addition, the trustee of Trust, who is not *A* or a descendant of *M*, has the power to make discretionary distributions of principal to the living descendants of *M* and to any organizations described in section 1361(c)(6). The potential current beneficiaries of Trust for any period will be *A*, each then-living descendant of M, and each exempt organization described in section 1361(c)(6) that receives a distribution during that period. In addition, the class of exempt organizations will be counted as one potential current beneficiary.

(ix) *Example 9. Power to distribute to a class of named charitable organizations not pursuant to a power of appointment. M* creates Trust from which *A* has a right to all net income and funds it with S corporation stock. In addition, the trustee of Trust, who is not *A* or a descendant of *M*, has the power to make discretionary distributions of principal to the living descendants of *M* and to *X*, *Y*, and *Z*, each of which is an organization described in section 1361(c)(6). The potential current beneficiaries of Trust for any period will be *A*, *X*, *Y*, *Z*, and each living descendant of *M*.

(9) *Effective date.* This paragraph (m) is applicable for taxable years of ESBTs beginning on and after May 14, 2002. Paragraphs (m)(2)(ii)(A) and (m)(4)(iii) and (vi) of this section and *Examples 2*, *5*, and *7* through *9* in paragraphs (m)(8)(ii), (v), and (vii) through (ix), respectively, of this section are effective on *August 14, 2008*. Paragraphs (m)(1)(ii)(D), (m)(2)(ii)(E)(*2*), (m)(4)(i), (m)(5)(iii), and (m)(8) of this section apply to all ESBTs after December 31, 2017.

[T.D. 8419, 57 FR 22649, May 29, 1992; 57 FR 28613, June 26, 1992, as amended by T.D. 8600, 60 FR 37581, July 21, 1995; 60 FR 49976, Sept. 27, 1995; 60 FR 58234, Nov. 27, 1995; 61 FR 2869, Jan. 29, 1996; T.D. 8869, 65 FR 3849, Jan. 25, 2000; T.D. 8940, 66 FR 9929, 9957, Feb. 13, 2001; T.D. 8994, 67 FR 34397, May 14, 2002; T.D. 9078, 68 FR 42252, July 17, 2003; T.D. 9422, 73 FR 47527, Aug. 14, 2008; T.D. 9868, 84 FR 28216, June 18, 2019]

§ 1.1361–2 Definitions relating to S corporation subsidiaries.

(a) *In general.* The term *qualified subchapter S subsidiary* (QSub) means any domestic corporation that is not an ineligible corporation (as defined in section 1361(b)(2) and the regulations thereunder), if—

(1) 100 percent of the stock of such corporation is held by an S corporation; and

(2) The S corporation properly elects to treat the subsidiary as a QSub under § 1.1361–3.

(b) *Stock treated as held by S corporation*. For purposes of satisfying the 100 percent stock ownership requirement in section 1361(b)(3)(B)(i) and paragraph (a)(1) of this section—

(1) Stock of a corporation is treated as held by an S corporation if the S corporation is the owner of that stock for Federal income tax purposes; and

(2) Any outstanding instruments, obligations, or arrangements of the corporation which would not be considered stock for purposes of section 1361(b)(1)(D) if the corporation were an S corporation are not treated as outstanding stock of the QSub.

(c) *Straight debt safe harbor*. Section 1.1361–1(l)(5)(iv) and (v) apply to an obligation of a corporation for which a QSub election is made if that obligation would satisfy the definition of straight debt in § 1.1361–1(l)(5) if issued by the S corporation.

(d) *Examples*. The following examples illustrate the application of this section:

Example 1. X, an S corporation, owns 100 percent of Y, a corporation for which a valid QSub election is in effect for the taxable year. Y owns 100 percent of Z, a corporation otherwise eligible for QSub status. X may elect to treat Z as a QSub under section 1361(b)(3)(B)(ii).

Example 2. Assume the same facts as in *Example 1*, except that Y is a business entity that is disregarded as an entity separate from its owner under § 301.7701–2(c)(2) of this chapter. X may elect to treat Z as a QSub.

Example 3. Assume the same facts as in *Example 1*, except that Y owns 50 percent of Z, and X owns the other 50 percent. X may elect to treat Z as a QSub.

Example 4. Assume the same facts as in *Example 1*, except that Y is a C corporation. Although Y is a domestic corporation that is otherwise eligible to be a QSub, no QSub election has been made for Y. Thus, X is not treated as holding the stock of Z. Consequently, X may not elect to treat Z as a QSub.

Example 5. Individuals A and B own 100 percent of the stock of corporation X, an S corporation, and, except for C's interest (described below), X owns 100 percent of corporation Y, a C corporation. Individual C holds an instrument issued by Y that is considered to be equity under general principles of tax law but would satisfy the definition of straight debt under § 1.1361–1(l)(5) if Y were an S corporation. In determining whether X owns 100 percent of Y for purposes of making the QSub election, the instrument held by C is not considered outstanding stock. In addition, under § 1.1361–1(l)(5)(v), the QSub election is not treated as an exchange of debt for stock with respect to such instrument, and § 1.1361–1(l)(5)(iv) applies to determine the tax treatment of payments on the instrument while Y's QSub election is in effect.

[T.D. 8869, 65 FR 3849, Jan. 25, 2000]

§ 1.1361–3 QSub election.

(a) *Time and manner of making election*—(1) *In general*. The corporation for which the QSub election is made must meet all the requirements of section 1361(b)(3)(B) at the time the election is made and for all periods for which the election is to be effective.

(2) *Manner of making election*. Except as provided in section 1361(b)(3)(D) and § 1.1361–5(c) (five-year prohibition on reelection), an S corporation may elect to treat an eligible subsidiary as a QSub by filing a completed form to be prescribed by the IRS. The election form must be signed by a person authorized to sign the S corporation's return required to be filed under section 6037. Unless the election form provides otherwise, the election must be submitted to the service center where the subsidiary filed its most recent tax return (if applicable), and, if an S corporation forms a subsidiary and makes a valid QSub election (effective upon the date of the subsidiary's formation) for the subsidiary, the election should be submitted to the service center where the S corporation filed its most recent return.

(3) *Time of making election*. A QSub election may be made by the S corporation parent at any time during the taxable year.

(4) *Effective date of election*. A QSub election will be effective on the date specified on the election form or on the date the election form is filed if no date is specified. The effective date specified on the form cannot be more than two months and 15 days prior to the date of filing and cannot be more than 12 months after the date of filing. For this purpose, the definition of the term *month* found in § 1.1362–

6(a)(2)(ii)(C) applies. If an election form specifies an effective date more than two months and 15 days prior to the date on which the election form is filed, it will be effective two months and 15 days prior to the date it is filed. If an election form specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it is filed.

(5) *Example*. The following example illustrates the application of paragraph (a)(4) of this section:

Example. X has been a calendar year S corporation engaged in a trade or business for several years. X acquires the stock of Y, a calendar year C corporation, on April 1, 2002. On August 10, 2002, X makes an election to treat Y as a QSub. Unless otherwise specified on the election form, the election will be effective as of August 10, 2002. If specified on the election form, the election may be effective on some other date that is not more than two months and 15 days prior to August 10, 2002, and not more than 12 months after August 10, 2002.

(6) *Extension of time for making a QSub election*. An extension of time to make a QSub election may be available under the procedures applicable under §§ 301.9100–1 and 301.9100–3 of this chapter.

(b) *Revocation of QSub election*—(1) *Manner of revoking QSub election*. An S corporation may revoke a QSub election under section 1361 by filing a statement with the service center where the S corporation's most recent tax return was properly filed. The revocation statement must include the names, addresses, and taxpayer identification numbers of both the parent S corporation and the QSub, if any. The statement must be signed by a person authorized to sign the S corporation's return required to be filed under section 6037.

(2) *Effective date of revocation*. The revocation of a QSub election is effective on the date specified on the revocation statement or on the date the revocation statement is filed if no date is specified. The effective date specified on the revocation statement cannot be more than two months and 15 days prior to the date on which the revocation statement is filed and cannot be more than 12 months after the date on which the revocation statement is filed. If a revocation statement specifies an effective date more than two months and 15 days prior to the date on which the statement is filed, it will be effective two months and 15 days prior to the date it is filed. If a revocation statement specifies an effective date more than 12 months after the date on which the statement is filed, it will be effective 12 months after the date it is filed.

(3) *Revocation after termination*. A revocation may not be made after the occurrence of an event that renders the subsidiary ineligible for QSub status under section 1361(b)(3)(B).

(4) *Revocation before QSub election effective*. For purposes of Section 1361(b)(3)(D) and § 1.1361–5(c) (five-year prohibition on re-election), a revocation effective on the first day the QSub election was to be effective will not be treated as a termination of a QSub election.

[T.D. 8869, 65 FR 3850, Jan. 25, 2000]

§ 1.1361–4 Effect of QSub election.

(a) *Separate existence ignored*—(1) *In general*. Except as otherwise provided in paragraphs (a)(3), (a)(6), (a)(7), (a)(8), and (a)(9) of this section, for Federal tax purposes—

(i) A corporation that is a QSub shall not be treated as a separate corporation; and

(ii) All assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and items of income, deduction, and credit of the S corporation.

(2) *Liquidation of subsidiary*—(i) *In general*. If an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation. Except as provided in paragraph (a)(5) of this section, the tax treatment of the liquidation or of a larger transaction that includes the liquidation will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. Thus, for example, if an S corporation forms a subsidiary and makes a valid QSub election (effective upon the date of the subsidiary's formation) for the subsidiary, the transfer of assets to the subsidiary and the deemed liquidation are disregarded,

and the corporation will be deemed to be a QSub from its inception.

(ii) *Examples*. The following examples illustrate the application of this paragraph (a)(2)(i) of this section:

Example 1. Corporation X acquires all of the outstanding stock of solvent corporation Y from an unrelated individual for cash and short-term notes. Thereafter, as part of the same plan, X immediately makes an S election and a QSub election for Y. Because X acquired all of the stock of Y in a qualified stock purchase within the meaning of section 338(d)(3), the liquidation described in paragraph (a)(2) of this section is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under sections 332 and 337.

Example 2. Corporation X, pursuant to a plan, acquires all of the outstanding stock of corporation Y from the shareholders of Y solely in exchange for 10 percent of the voting stock of X. Prior to the transaction, Y and its shareholders are unrelated to X. Thereafter, as part of the same plan, X immediately makes an S election and a QSub election for Y. The transaction is a reorganization described in section 368(a)(1)(C), assuming the other conditions for reorganization treatment (e.g., continuity of business enterprise) are satisfied.

Example 3. After the expiration of the transition period provided in paragraph (a)(5)(i) of this section, individual A, pursuant to a plan, contributes all of the outstanding stock of Y to his wholly owned S corporation, X, and immediately causes X to make a QSub election for Y. The transaction is a reorganization under section 368(a)(1)(D), assuming the other conditions for reorganization treatment (e.g., continuity of business enterprise) are satisfied. If the sum of the amount of liabilities of Y treated as assumed by X exceeds the total of the adjusted basis of the property of Y, then section 357(c) applies and such excess is considered as gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(iii) *Adoption of plan of liquidation*. For purposes of satisfying the requirement of adoption of a plan of liquidation under section 332, unless a formal plan of liquidation that contemplates the QSub election is adopted on an earlier date, the making of the QSub election is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation described in paragraph (a)(2)(i) of this section.

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

Example. Corporation X owns 75 percent of a solvent corporation Y, and individual A owns the remaining 25 percent of Y. As part of a plan to make a QSub election for Y, X causes Y to redeem A's 25 percent interest on June 1 for cash and makes a QSub election for Y effective on June 3. The making of the QSub election is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation. The deemed liquidation satisfies the requirements of section 332.

(v) *Stock ownership requirements of section 332*. The deemed exercise of an option under §1.1504–4 and any instruments, obligations, or arrangements that are not considered stock under §1.1361–2(b)(2) are disregarded in determining if the stock ownership requirements of section 332(b) are met with respect to the deemed liquidation provided in paragraph (a)(2)(i) of this section.

(3) *Treatment of banks*—(i) *In general*. If an S corporation is a bank, or if an S corporation makes a valid QSub election for a subsidiary that is a bank, any special rules applicable to banks under the Internal Revenue Code continue to apply separately to the bank parent or bank subsidiary as if the deemed liquidation of any QSub under paragraph (a)(2) of this section had not occurred (except as other published guidance may apply section 265(b) and section 291(a)(3) and (e)(1)(B) not only to the bank parent or bank subsidiary but also to any QSub deemed to have liquidated under paragraph (a)(2) of this section). For any QSub that is a bank, however, all assets, liabilities, and items of income, deduction, and credit of the QSub, as determined in accordance with the special bank rules, are treated as assets, liabilities, and items of income, deduction, and credit of the S corporation. For purposes of this paragraph (a)(3)(i), the term bank has the same meaning as in section 581.

(ii) *Examples*. The following examples illustrate the application of this paragraph (a)(3):

Example 1. X, an S corporation, is a bank as defined in section 581. X owns 100 percent of Y and Z, corporations for which valid QSub elections are in effect. Y is a bank as defined

in section 581, and Z is not a financial institution. Pursuant to paragraph (a)(3)(i) of this section, any special rules applicable to banks under the Internal Revenue Code continue to apply separately to X and Y and do not apply to Z. Thus, for example, section 265(b), which provides special rules for interest expense deductions of banks, applies separately to X and Y. That is, X and Y each must make a separate determination under section 265(b) of interest expense allocable to tax-exempt interest, and no deduction is allowed for that interest expense. Section 265(b) does not apply to Z except as published guidance may provide otherwise.

Example 2. X, an S corporation, is a bank holding company and thus is not a bank as defined in section 581. X owns 100 percent of Y, a corporation for which a valid QSub election is in effect. Y is a bank as defined in section 581. Pursuant to paragraph (a)(3)(i) of this section, any special rules applicable to banks under the Internal Revenue Code continue to apply to Y and do not apply to X. However, all of Y's assets, liabilities, and items of income, deduction, and credit, as determined in accordance with the special bank rules, are treated as those of X. Thus, for example, section 582(c), which provides special rules for sales and exchanges of debt by banks, applies only to sales and exchanges by Y. However, any gain or loss on such a transaction by Y that is considered ordinary income or ordinary loss pursuant to section 582(c) is treated as ordinary income or ordinary loss of X.

(iii) *Effective date.* This paragraph (a)(3) applies to taxable years beginning after December 31, 1996.

(4) *Treatment of stock of QSub.* Except for purposes of section 1361(b)(3)(B)(i) and § 1.1361–2(a)(1), the stock of a QSub shall be disregarded for all Federal tax purposes.

(5) *Transitional relief*—(i) *General rule.* If an S corporation and another corporation (the related corporation) are persons specified in section 267(b) prior to an acquisition by the S corporation of some or all of the stock of the related corporation followed by a QSub election for the related corporation, the step transaction doctrine will not apply to determine the tax consequences of the acquisition. This paragraph (a)(5) shall apply to QSub elections effective before January 1, 2001.

(ii) *Examples.* The following examples illustrate the application of this paragraph (a)(5):

Example 1. Individual A owns 100 percent of the stock of X, an S corporation. X owns 79 percent of the stock of Y, a solvent corporation, and A owns the remaining 21 percent. On May 4, 1998, A contributes its Y stock to X in exchange for X stock. X makes a QSub election with respect to Y effective immediately following the transfer. The liquidation described in paragraph (a)(2) of this section is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under sections 332 and 337. The contribution by A of the Y stock qualifies under section 351, and no gain or loss is recognized by A, X, or Y.

Example 2. Individual A owns 100 percent of the stock of two solvent S corporations, X and Y. On May 4, 1998, A contributes the stock of Y to X. X makes a QSub election with respect to Y immediately following the transfer. The liquidation described in paragraph (a)(2) of this section is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under sections 332 and 337. The contribution by A of the Y stock to X qualifies under section 351, and no gain or loss is recognized by A, X, or Y. Y is not treated as a C corporation for any period solely because of the transfer of its stock to X, an ineligible shareholder. Compare *Example 3* of § 1.1361–4(a)(2)(ii).

(6) *Treatment of certain QSubs*—(i) *In general.* A QSub, even though it is generally not treated as a corporation separate from the S corporation, is treated as a separate corporation for purposes of:

(A) Federal tax liabilities of the QSub with respect to any taxable period for which the QSub was treated as a separate corporation.

(B) Federal tax liabilities of any other entity for which the QSub is liable.

(C) Refunds or credits of Federal tax.

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

Example 1. X has owned all of the outstanding stock of Y, a domestic corporation that reports its taxes on a calendar year basis, since 2001. X and Y do not report their taxes on a consolidated basis. For 2003, X makes a timely S election and simultaneously makes a QSub election for Y. In 2004, the Internal Revenue Service (IRS) seeks to extend the period of limitations on assessment for Y's 2001 taxable year. Because Y was treated as a separate corporation for its 2001 taxable year, Y is the proper party to sign the consent to extend the period of limitations.

Example 2. The facts are the same as in *Example 1*, except that in 2004, the IRS determines that Y miscalculated and underreported its income tax liability for 2001. Because Y was treated as a separate corporation for its 2001 taxable year, the deficiency for Y's 2001 taxable year may be assessed against Y and, in the event that Y fails to pay the liability after notice and demand, a general tax lien will arise against all of Y's property and rights to property.

Example 3. X is a QSub of Y. In 2001, Z, a domestic corporation that reports its taxes on a calendar year basis, merges into X in a state law merger. Z was not a member of a consolidated group at any time during its taxable year ending in December 2000. Under the applicable state law, X is the successor to Z and is liable for all of Z's debts. In 2003, the IRS seeks to extend the period of limitations on assessment for Z's 2000 taxable year. Because X is the successor to Z and is liable for Z's 2000 taxes that remain unpaid, X is the proper party to execute the consent to extend the period of limitations on assessment.

(iii) *Effective date*. This paragraph (a)(6) applies on or after April 1, 2004.

(7) *Treatment of QSubs for purposes of employment taxes*—(i) *In general*. A QSub is treated as a separate corporation for purposes of Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code).

(ii) *Effective/applicability date*. This paragraph (a)(7) applies with respect to wages paid on or after January 1, 2009.

(8) *Treatment of QSubs for purposes of certain excise taxes*—(i) *In general*. A QSub is treated as a separate corporation for purposes of—

(A) Federal tax liabilities imposed by Chapters 31, 32 (other than section 4181), 33, 34, 35, 36 (other than section 4461), 38, and 49 of the Internal Revenue Code, or any floor stocks tax imposed on articles subject to any of these taxes;

(B) Collection of tax imposed by Chapters 33 and 49 of the Internal Revenue Code;

(C) Registration under sections 4101, 4222, and 4412;

(D) Claims of a credit (other than a credit under section 34), refund, or payment related to a tax described in paragraph (a)(8)(i)(A) of this section or under section 6426 or 6427; and

(E) Assessment and collection of an assessable payment imposed by section 4980H and reporting required by section 6056.

(ii) *Effective/applicability date*. (A) Except as provided in this paragraph (a)(8)(ii), paragraph (a)(8) of this section applies to liabilities imposed and actions first required or permitted in periods beginning on or after January 1, 2008.

(B) References to Chapter 49 in paragraph (a)(8) of this section apply to taxes imposed on amounts paid on or after July 1, 2012.

(C) Paragraph (a)(8)(i)(E) of this section applies for periods after December 31, 2014.

(9) *Information returns*—(i) *In general*. Except to the extent provided by the Secretary or Commissioner in guidance (including forms or instructions), paragraph (a)(1) of this section shall not apply to part III of subchapter A of chapter 61, relating to information returns.

(ii) *Effective/applicability date*. This paragraph (a)(9) is effective on *August 14, 2008*.

(b) *Timing of the liquidation*—(1) *In general*. Except as otherwise provided in paragraph (b)(3) or (4) of this section, the liquidation described in paragraph (a)(2) of this section occurs at the close of the day before the QSub election is effective. Thus, for example, if a C corporation elects to be treated as an S corporation and makes a QSub election (effective the same date as the S election) with respect to a subsidiary, the liquidation occurs immediately before the S election becomes effective, while the S electing parent is still a C corporation.

(2) *Application to elections in tiered situations*. When QSub elections for a tiered group of subsidiaries are effective on the same date, the S corporation may specify the order of the liquidations. If no order is specified, the liquidations that are deemed to occur as a result of the QSub elections will be treated as occurring first for the lowest tier entity and proceed successively upward until all of the liquidations under paragraph (a)(2) of this section have occurred. For example, S, an S corporation, owns 100 percent of C, the common parent of an affiliated group of corporations that includes X and Y. C owns all of the stock of X and X owns

all of the stock of Y. S elects under §1.1361–3 to treat C, X and Y as QSubs effective on the same date. If no order is specified for the elections, the following liquidations are deemed to occur as a result of the elections, with each successive liquidation occuring on the same day immediately after the preceding liquidation: Y is treated as liquidating into X, then X is treated as liquidating into C, and finally C is treated as liquidating into S.

(3) *Acquisitions.* (i) *In general.* If an S corporation does not own 100 percent of the stock of the subsidiary on the day before the QSub election is effective, the liquidation described in paragraph (a)(2) of this section occurs immediately after the time at which the S corporation first owns 100 percent of the stock.

(ii) *Special rules for acquired S corporations.* Except as provided in paragraph (b)(4) of this section, if a corporation (Y) for which an election under section 1362(a) was in effect is acquired, and a QSub election is made effective on the day Y is acquired, Y is deemed to liquidate into the S corporation at the beginning of the day the termination of its S election is effective. As a result, if corporation X acquires Y, an S corporation, and makes an S election for itself and a QSub election for Y effective on the day of acquisition, Y liquidates into X at the beginning of the day when X's S election is effective, and there is no period between the termination of Y's S election and the deemed liquidation of Y during which Y is a C corporation. Y's taxable year ends for all Federal income tax purposes at the close of the preceding day. Furthermore, if Y owns Z, a corporation for which a QSub election was in effect prior to the acquisition of Y by X, and X makes QSub elections for Y and Z, effective on the day of acquisition, the transfer of assets to Z and the deemed liquidation of Z are disregarded. See §§1.1361–4(a)(2) and 1.1361–5(b)(1)(i).

(4) *Coordination with section 338 election.* An S corporation that makes a qualified stock purchase of a target may make an election under section 338 with respect to the acquisition if it meets the requirements for the election, and may make a QSub election with respect to the target. If an S corporation makes an election under section 338 with respect to a subsidiary acquired in a qualified stock purchase, a QSub election made with respect to that subsidiary is not effective before the day after the acquisition date (within the meaning of section 338(h)(2)). If the QSub election is effective on the day after the acquisition date, the liquidation under paragraph (a)(2) of this section occurs immediately after the deemed asset purchase by the new target corporation under section 338. If an S corporation makes an election under section 338 (without a section 338(h)(10) election) with respect to a target, the target must file a final return as a C corporation reflecting the deemed sale. *See §1.338–10(a).* If the target was an S corporation on the day before the acquisition date, the final return as a C corporation must reflect the activities of the target for the acquisition date, including the deemed sale. *See §1.338–10(a)(3).*

(c) *Carryover of disallowed losses and deductions.* If an S corporation (S1) acquires the stock of another S corporation (S2), and S1 makes a QSub election with respect to S2 effective on the day of the acquisition, see §1.1366–2(c)(1) for provisions relating to the carryover of losses and deductions with respect to a former shareholder of S2 that may be available to that shareholder as a shareholder of S1.

(d) *Examples.* The following examples illustrate the application of this section:

Example 1. X, an S corporation, owns 100 percent of the stock of Y, a C corporation. On June 2, 2002, X makes a valid QSub election for Y, effective June 2, 2002. Assume that, under general principles of tax law, including the step transaction doctrine, X's acquisition of the Y stock and the subsequent QSub election would not be treated as related. The liquidation described in paragraph (a)(2) of this section occurs at the close of the day on June 1, 2002, the day before the QSub election is effective, and the plan of liquidation is considered adopted on that date. Y's taxable year and separate existence for Federal tax purposes end at the close of June 1, 2002.

Example 2. X, a C corporation, owns 100 percent of the stock of Y, another C corporation. On December 31, 2002, X makes an election under section 1362 to be treated as an S corporation and a valid QSub election for Y,

both effective January 1, 2003. Assume that, under general principles of tax law, including the step transaction doctrine, X's acquisition of the Y stock and the subsequent QSub election would not be treated as related. The liquidation described in paragraph (a)(2) of this section occurs at the close of December 31, 2002, the day before the QSub election is effective. The QSub election for Y is effective on the same day that X's S election is effective, and the deemed liquidation is treated as occurring before the S election is effective, when X is still a C corporation. Y's taxable year ends at the close of December 31, 2002. See § 1.381(b)–1.

Example 3. On June 1, 2002, X, an S corporation, acquires 100 percent of the stock of Y, an existing S corporation, for cash in a transaction meeting the requirements of a qualified stock purchase (QSP) under section 338. X immediately makes a QSub election for Y effective June 2, 2002, and also makes a joint election under section 338(h)(10) with the shareholder of Y. Under section 338(a) and § 1.338(h)(10)–1(d)(3), Y is treated as having sold all of its assets at the close of the acquisition date, June 1, 2002. Y is treated as a new corporation which purchased all of those assets as of the beginning of June 2, 2002, the day after the acquisition date. Section 338(a)(2). The QSub election is effective on June 2, 2002, and the liquidation under paragraph (a)(2) of this section occurs immediately after the deemed asset purchase by the new corporation.

Example 4. X, an S corporation, owns 100 percent of Y, a corporation for which a QSub election is in effect. On May 12, 2002, a date on which the QSub election is in effect, X issues Y a $10,000 note under state law that matures in ten years with a market rate of interest. Y is not treated as a separate corporation, and X's issuance of the note to Y on May 12, 2002, is disregarded for Federal tax purposes.

Example 5. X, an S corporation, owns 100 percent of the stock of Y, a C corporation. At a time when Y is indebted to X in an amount that exceeds the fair market value of Y's assets, X makes a QSub election effective on the date it is filed with respect to Y. The liquidation described in paragraph (a)(2) of this section does not qualify under sections 332 and 337 and, thus, Y recognizes gain or loss on the assets distributed, subject to the limitations of section 267.

[T.D. 8869, 65 FR 3850, Jan. 25, 2000; 65 FR 16318, Mar. 28, 2000; T.D. 8940, 66 FR 9929, 9957, Feb. 13, 2001; T.D. 9183, 70 FR 9221, Feb. 25, 2005; T.D. 9356, 72 FR 45893, Aug. 16, 2007; T.D. 9422, 73 FR 47530, Aug. 14, 2008; T.D. 9596, 77 FR 37806, June 25, 2012; T.D. 9655, 79 FR 8577, Feb. 12, 2014: T.D. 9670, 79 FR 36205, June 26, 2014]

§ 1.1361–5 Termination of QSub election.

(a) In *general*—(1) *Effective date.* The termination of a QSub election is effective—

(i) On the effective date contained in the revocation statement if a QSub election is revoked under § 1.1361–3(b);

(ii) At the close of the last day of the parent's last taxable year as an S corporation if the parent's S election terminates under § 1.1362–2; or

(iii) At the close of the day on which an event (other than an event described in paragraph (a)(1)(ii) of this section) occurs that renders the subsidiary ineligible for QSub status under section 1361(b)(3)(B).

(2) *Information to be provided upon termination of QSub election by failure to qualify as a QSub.* If a QSub election terminates because an event renders the subsidiary ineligible for QSub status, the S corporation must attach to its return for the taxable year in which the termination occurs a notification that a QSub election has terminated, the date of the termination, and the names, addresses, and employer identification numbers of both the parent corporation and the QSub.

(3) *QSub joins a consolidated group.* If a QSub election terminates because the S corporation becomes a member of a consolidated group (and no election under section 338(g) is made) the principles of § 1.1502–76(b)(1)(ii)(A)(2) (relating to a special rule for S corporations that join a consolidated group) apply to any QSub of the S corporation that also becomes a member of the consolidated group at the same time as the S corporation. See *Example 4* of paragraph (a)(4) of this section.

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

Example 1. Termination because parent's S election terminates. X, an S corporation, owns 100 percent of Y. A QSub election is in effect with respect to Y for 2001. Effective on January 1, 2002, X revokes its S election. Because X is no longer an S corporation, Y no longer qualifies as a QSub at the close of December 31, 2001.

Example 2. Termination due to transfer of QSub stock. X, an S corporation, owns 100 percent of Y. A QSub election is in effect with respect to Y. On December 10, 2002, X

sells one share of Y stock to A, an individual. Because X no longer owns 100 percent of the stock of Y, Y no longer qualifies as a QSub. Accordingly, the QSub election made with respect to Y terminates at the close of December 10, 2002.

Example 3. No termination on stock transfer between QSub and parent. X, an S corporation, owns 100 percent of the stock of Y, and Y owns 100 percent of the stock of Z. QSub elections are in effect with respect to both Y and Z. Y transfers all of its Z stock to X. Because X is treated as owning the stock of Z both before and after the transfer of stock solely for purposes of determining whether the requirements of section 1361(b)(3)(B)(i) and §1.1361–2(a)(1) have been satisfied, the transfer of Z stock does not terminate Z's QSub election. Because the stock of Z is disregarded for all other Federal tax purposes, no gain is recognized under section 311.

Example 4. Termination due to acquisition of S parent by a consolidated group. X, an S corporation, owns 100 percent of Y, a corporation for which a QSub election is in effect. Z, the common parent of a consolidated group of corporations, acquires 80 percent of the stock of X on June 1, 2002. Z does not make an election under section 338(g) with respect to the purchase of X stock. X's S election terminates as of the close of the preceding day, May 31, 2002. Y's QSub election also terminates at the close of May 31, 2002. Under §1.1502–76(b)(1)(ii)(A)(2) and paragraph (a)(3) of this section, X and Y become members of Z's consolidated group of corporations as of the beginning of the day June 1, 2002.

Example 5. Termination due to acquisition of QSub by a consolidated group. The facts are the same as in Example 4, except that Z acquires 80 percent of the stock of Y (instead of X) on June 1, 2002. In this case, Y's QSub election terminates as of the close of June 1, 2002, and, under §1.1502–76(b)(1)(ii)(A)(1), Y becomes a member of the consolidated group at that time.

(b) *Effect of termination of QSub election*—(1) *Formation of new corporation*—(i) *In general.* If a QSub election terminates under paragraph (a) of this section, the former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation. The tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. For purposes of determining the application of section 351 with respect to this transaction, instruments, obligations, or other arrangements that are not treated as stock of the QSub under §1.1361–2(b) are disregarded in determining control for purposes of section 368(c) even if they are equity under general principles of tax law.

(ii) *Termination for tiered QSubs.* If QSub elections terminate for tiered QSubs on the same day, the formation of any higher tier subsidiary precedes the formation of its lower tier subsidiary. See Example 6 in paragraph (b)(3) of this section.

(2) *Carryover of disallowed losses and deductions.* If a QSub terminates because the S corporation distributes the QSub stock to some or all of the S corporation's shareholders in a transaction to which section 368(a)(1)(D) applies by reason of section 355 (or so much of section 356 as relates to section 355), see §1.1366–2(c)(2) for provisions relating to the carryover of disallowed losses and deductions that may be available.

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

Example 1. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X sells 21 percent of the Y stock to Z, an unrelated corporation, for cash, thereby terminating the QSub election. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for Y stock immediately before the termination from the S corporation. The deemed exchange by X of assets for Y stock does not qualify under section 351 because X is not in control of Y within the meaning of section 368(c) immediately after the transfer as a result of the sale of stock to Z. Therefore, X must recognize gain, if any, on the assets transferred to Y in exchange for its stock. X's losses, if any, on the assets transferred are subject to the limitations of section 267.

Example 2. (i) X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. As part of a plan to sell a portion of Y, X causes Y to merge into T, a limited liability company wholly owned by X that is disregarded as an entity separate from its owner for Federal tax purposes. X then sells 21 percent of T to Z, an unrelated corporation, for cash. Following the sale, no entity classification election is made under §301.7701–3(c) of this chapter to treat the limited liability company as an association for Federal tax purposes.

(ii) The merger of Y into T causes a termination of Y's QSub election. The new corporation (Newco) that is formed as a result of the termination is immediately merged into T, an entity that is disregarded for Federal tax purposes. Because, at the end of the series of transactions, the assets continue to be held by X for Federal tax purposes, under step transaction principles, the formation of Newco and the transfer of assets pursuant to the merger of Newco into T are disregarded. The sale of 21 percent of T is treated as a sale of a 21 percent undivided interest in each of T's assets. Immediately thereafter, X and Z are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

(iii) Under section 1001, X recognizes gain or loss from the deemed sale of the 21 percent interest in each asset of the limited liability company to Z. Under section 721(a), no gain or loss is recognized by X and Z as a result of the deemed contribution of their respective interests in the assets to the partnership in exchange for ownership interests in the partnership.

Example 3. Assume the same facts as in *Example 1*, except that, instead of purchasing Y stock, Z contributes to Y an operating asset in exchange for 21 percent of the Y stock. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for Y stock immediately before the termination. Because X and Z are co-transferors that control the transferee immediately after the transfer, the transaction qualifies under section 351.

Example 4. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X distributes all of the Y stock pro rata to its shareholders, and the distribution terminates the QSub election. The transaction can qualify as a distribution to which sections 368(a)(1)(D) and 355 apply if the transaction otherwise satisfies the requirements of those sections.

Example 5. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X subsequently revokes the QSub election. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the revocation from its S corporation parent in a deemed exchange for Y stock. On a subsequent date, X sells 21 percent of the stock of Y to Z, an unrelated corporation, for cash. Assume that under general principles of tax law including the step transaction doctrine, the sale is not taken into account in determining whether X is in control of Y immediately after the deemed exchange of assets for stock. The deemed exchange by X of assets for Y stock and the deemed assumption by Y of its liabilities qualify under section 351 because, for purposes of that section, X is in control of Y within the meaning of section 368(c) immediately after the transfer.

Example 6. (i) X, an S corporation, owns 100 percent of the stock of Y, and Y owns 100 percent of the stock of Z. Y and Z are corporations for which QSub elections are in effect. X subsequently revokes the QSub elections and the effective date specified on each revocation statement is June 26, 2002, a date that is less than 12 months after the date on which the revocation statements are filed.

(ii) Immediately before the QSub elections terminate, Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from X in exchange for the stock of Y. Z is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from Y in exchange for the stock of Z.

Example 7. (i) The facts are the same as in Example 6, except that, prior to June 26, 2002 (the effective date of the revocations), Y distributes the Z stock to X under state law.

(ii) Immediately before the QSub elections terminate, Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from X in exchange for the stock of Y. Z is also treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from X in exchange for the stock of Z.

Example 8. Merger of parent into QSub. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X merges into Y under state law, causing the QSub election for Y to terminate, and Y survives the merger. The formation of the new corporation, Y, and the merger of X into Y can qualify as a reorganization described in section 368(a)(1)(F) if the transaction otherwise satisfies the requirements of that section.

Example 9. Transfer of 100 percent of QSub. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. Z, an unrelated C corporation, acquires 100 percent of the stock of Y. The deemed formation of Y by X (as a consequence of the termination of Y's QSub election) is disregarded for Federal income tax purposes. The transaction is treated as a transfer of the assets of Y to Z, followed by Z's transfer of these assets to the capital of Y in exchange for Y stock. Furthermore, if Z is an S corporation and makes a QSub election for Y effective as of the acquisition, Z's transfer of the assets of Y in exchange for Y stock, followed by the immediate liquidation of Y as a consequence of the QSub election are disregarded for Federal income tax purposes.

(c) *Election after QSub termination*—(1) *In general.* Absent the Commissioner's consent, and except as provided in

paragraph (c)(2) of this section, a corporation whose QSub election has terminated under paragraph (a) of this section (or a successor corporation as defined in§1.1362–5(b)) may not make an S election under section 1362 or have a QSub election under section 1361(b)(3)(B)(ii) made with respect to it for five taxable years (as described in section 1361(b)(3)(D)). The Commissioner may permit an S election by the corporation or a new QSub election with respect to the corporation before the five-year period expires. The corporation requesting consent to make the election has the burden of establishing that, under the relevant facts and circumstances, the Commissioner should consent to a new election.

(2) *Exception*. In the case of S and QSub elections effective after December 31, 1996, if a corporation's QSub election terminates, the corporation may, without requesting the Commissioner's consent, make an S election or have a QSub election made with respect to it before the expiration of the five-year period described in section 1361(b)(3)(D) and paragraph (c)(1) of this section, provided that—

(i) Immediately following the termination, the corporation (or its successor corporation) is otherwise eligible to make an S election or have a QSub election made for it; and

(ii) The relevant election is made effective immediately following the termination of the QSub election.

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

Example 1. Termination upon distribution of QSub stock to shareholders of parent. X, an S corporation, owns Y, a QSub. X distributes all of its Y stock to X's shareholders. The distribution terminates the QSub election because Y no longer satisfies the requirements of a QSub. Assuming Y is otherwise eligible to be treated as an S corporation, Y's shareholders may elect to treat Y as an S corporation effective on the date of the stock distribution without requesting the Commissioner's consent.

Example 2. Sale of 100 percent of QSub stock. X, an S corporation, owns Y, a QSub. X sells 100 percent of the stock of Y to Z, an unrelated S corporation. Z may elect to treat Y as a QSub effective on the date of purchase without requesting the Commissioner's consent.

[T.D. 8869, 65 FR 3852, Jan. 25, 2000; 65 FR 16318, Mar. 28, 2000, as amended by T.D. 8869, 67 FR 65313, Oct. 24, 2002]

§ 1.1361–6 Effective date.

Except as provided in §§1.1361–4(a)(3)(iii), 1.1361–4(a)(5)(i), 1.1361–4(a)(6)(iii), 1.1361–4(a)(7)(ii), 1.1361–4(a)(8)(ii), 1.1361–4(a)(9), and 1.1361–5(c)(2), the provisions of §§1.1361–2 through 1.1361–5 apply to taxable years beginning on or after January 20, 2000; however, taxpayers may elect to apply the regulations in whole, but not in part (aside from those sections with special dates of applicability), for taxable years beginning on or after January 1, 2000, provided all affected taxpayers apply the regulations in a consistent manner. To make this election, the corporation and all affected taxpayers must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made. For purposes of this section, affected taxpayers means all taxpayers whose returns are affected by the election to apply the regulations.

[T.D. 8869, 65 FR 3854, Jan. 25, 2000, as amended by T.D. 9356, 72 FR 45893, Aug. 16, 2007; T.D. 9422, 73 FR 47530, Aug. 14, 2008]

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[T.D. 8449, 57 FR 55448, Nov. 25, 1992; 58 FR 3330, Jan. 8, 1993, as amended by T.D. 8869, 65 FR 3854, Jan. 25, 2000; T.D. 9422, 73 FR 47530, Aug. 14, 2008]

§ 1.1362–1 Election to be an S corporation.

(a) *In general.* Except as provided in § 1.1362–5, a small business corporation as defined in section 1361 may elect to be an S corporation under section 1362(a). An election may be made only with the consent of all of the shareholders of the corporation at the time of the election. See § 1.1362–6(a) for rules concerning the time and manner of making this election.

(b) *Years for which election is effective.* An election under section 1362(a) is effective for the entire taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, until the election is terminated.

[T.D. 8449, 57 FR 55449, Nov. 25, 1992]

§ 1.1362–2 Termination of election.

(a) *Termination by revocation*—(1) *In general.* An election made under section 1362(a) is terminated if the corporation revokes the election for any taxable year of the corporation for which the election is effective, including the first taxable year. A revocation may be made only with the consent of shareholders who, at the time the revocation is made, hold more than one-half of the number of issued and outstanding shares of stock (including non-voting stock) of the corporation. See § 1.1362–6(a) for rules concerning the time and manner of revoking an election made under section 1362(a).

(2) *When effective*—(i) *In general.* Except as provided in paragraph (a)(2)(ii) of this section, a revocation made during the taxable year and before the 16th day of the third month of the taxable year is effective on the first day of the taxable year and a revocation made after the 15th day of the third month of the taxable year is effective for the following taxable year. If a corporation makes an election to be an S corporation that is to be effective beginning with the next taxable year and revokes its election on or before the first day of the next taxable year, the corporation is deemed to have revoked its election on the first day of the next taxable year.

(ii) *Revocations specifying a prospective revocation date.* If a corporation specifies a date for revocation and the date is expressed in terms of a stated day, month, and year that is on or after the date the revocation is filed, the revocation is effective on and after the date so specified.

(iii) *Applicability of section 7503.* With respect to a revocation made under paragraph (a)(2) of this section, see section 7503 (addressing time for performance of acts where the last day occurs on a Saturday, Sunday, or legal holiday). This paragraph (a)(2)(iii) applies to revocations made under paragraph (a)(2) of this section effective after October 20, 2020. A corporation may apply this paragraph (a)(2)(iii) retroactively to a revocation made by the corporation under paragraph (a)(2) of this section effective on or before October 20, 2020.

(3) *Effect on taxable year of corporation.* In the case of a corporation that revokes its election to be an S corporation effective on the first day of the first taxable year for which its election is to be effective, any statement made with the election regarding a change in the corporation's taxable year has no effect.

(4) *Rescission of a revocation.* A corporation may rescind a revocation made under paragraph (a)(2) of this section at any time before the revocation becomes effective. A rescission may be made only with the consent of each person who consented to the revocation

and by each person who became a shareholder of the corporation within the period beginning on the first day after the date the revocation was made and ending on the date on which the rescission is made. See §1.1362–6(a) for rules concerning the time and manner of rescinding a revocation.

(b) *Termination by reason of corporation ceasing to be a small business corporation*—(1) *In general*. If a corporation ceases to be a small business corporation, as defined in section 1361(b), at any time on or after the first day of the first taxable year for which its election under section 1362(a) is effective, the election terminates. In the event of a termination under this paragraph (b)(1), the corporation should attach to its return for the taxable year in which the termination occurs a notification that a termination has occurred and the date of the termination.

(2) *When effective*. If an election terminates because of a specific event that causes the corporation to fail to meet the definition of a small business corporation, the termination is effective as of the date on which the event occurs. If a corporation makes an election to be an S corporation that is effective beginning with the following taxable year and is not a small business corporation on the first day of that following taxable year, the election is treated as having terminated on that first day. If a corporation is a small business corporation on the first day of the taxable year for which its election is effective, its election does not terminate even if the corporation was not a small business corporation during all or part of the period beginning after the date the election was made and ending before the first day of the taxable year for which the election is effective.

(3) *Effect on taxable year of corporation*. In the case of a corporation that fails to meet the definition of a small business corporation on the first day of the first taxable year for which its election to be an S corporation is to be effective, any statement made with the election regarding a change in the corporation's taxable year has no effect.

(c) *Termination by reason of excess passive investment income*—(1) *In general*. A corporation's election under section 1362(a) terminates if the corporation has subchapter C earnings and profits at the close of each of three consecutive taxable years and, for each of those taxable years, has passive investment income in excess of 25 percent of gross receipts. See section 1375 for the tax imposed on excess passive investment income.

(2) *When effective*. A termination under this paragraph (c) is effective on the first day of the first taxable year beginning after the third consecutive year in which the S corporation had excess passive investment income.

(3) *Subchapter C earnings and profits*. For purposes of this paragraph (c), *subchapter C earnings and profits* of a corporation are the earnings and profits of any corporation, including the S corporation or an acquired or predecessor corporation, for any period with respect to which an election under section 1362(a) (or under section 1372 of prior law) was not in effect. The subchapter C earnings and profits of an S corporation are modified as required by section 1371(c).

(4) *Gross receipts*—(i) *In general*. For purposes of this paragraph (c), *gross receipts* generally means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income and is not reduced by returns and allowances, cost of goods sold, or deductions.

(ii) *Special rules for sales of capital assets, stock and securities*—(A) *Sales of capital assets*. For purposes of this paragraph (c), gross receipts from the sales or exchanges of capital assets (as defined in section 1221), other than stock and securities, are taken into account only to the extent of capital gain net income (as defined in section 1222).

(B) *Sales of stock or securities*—(*1*) *In general*. For purposes of this paragraph (c), gross receipts from the sales or exchanges of stock or securities are taken into account only to the extent of gains therefrom. In addition, for purposes of computing gross receipts from sales or exchanges of stock or securities, losses do not offset gains.

(*2*) *Treatment of certain liquidations*. Gross receipts from the sales or exchanges of stock or securities do not include amounts described in section

1362(d)(3)(D)(iv), relating to the treatment of certain liquidations. For purposes of section 1362(d)(3)(D)(iv), stock of the liquidating corporation owned by an S corporation shareholder is not treated as owned by the S corporation.

(*3*) *Definition of stock or securities*. For purposes of this paragraph (c), *stock or securities* includes shares or certificates of stock, stock rights or warrants, or an interest in any corporation (including any joint stock company, insurance company, association, or other organization classified as a corporation under section 7701); an interest as a limited partner in a partnership; certificates of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral property, or lease; collateral trust certificates; voting trust certificates; bonds; debentures; certificates of indebtedness; notes; car trust certificates; bills of exchange; or obligations issued by or on behalf of a State, Territory, or political subdivision thereof.

(*4*) *General partner interests*—(*i*) *In general*. Except as provided in paragraph (c)(4)(ii)(B)(*4*)(*ii*) of this section, if an S corporation disposes of a general partner interest, the gain on the disposition is treated as gain from the sale of stock or securities to the extent of the amount the S corporation would have received as a distributive share of gain from the sale of stock or securities held by the partnership if all of the stock and securities held by the partnership had been sold by the partnership at fair market value at the time the S corporation disposes of the general partner interest. In applying this rule, the S corporation's distributive share of gain from the sale of stock or securities held by the partnership is not reduced to reflect any loss that would be recognized from the sale of stock or securities held by the partnership. In the case of tiered partnerships, the rules of this section apply by looking through each tier.

(*ii*) *Exception*. An S corporation that disposes of a general partner interest may treat the disposition, for purposes of this paragraph (c), in the same manner as the disposition of an interest as a limited partner.

(iii) *Other exclusions from gross receipts*. For purposes of this paragraph (c), gross receipts do not include—

(A) Amounts received in nontaxable sales or exchanges except to the extent that gain is recognized by the corporation on the sale or exchange; or

(B) Amounts received as a loan, as a repayment of a loan, as a contribution to capital, or on the issuance by the corporation of its own stock.

(5) *Passive investment income*—(i) *In general*. In general, *passive investment income* means gross receipts (as defined in paragraph (c)(4) of this section) derived from royalties, rents, dividends, interest, annuities, and gains from the sales or exchanges of stock or securities.

(ii) *Definitions*. For purposes of this paragraph (c)(5), the following definitions apply:

(A) *Royalties*—(*1*) *In general*. *Royalties* means all royalties, including mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trademarks, tradebrands, franchises, and other like property. The gross amount of royalties is not reduced by any part of the cost of the rights under which the royalties are received or by any amount allowable as a deduction in computing taxable income.

(*2*) *Royalties derived in the ordinary course of a trade or business*. *Royalties* does not include royalties derived in the ordinary course of a trade or business of franchising or licensing property. Royalties received by a corporation are derived in the ordinary course of a trade or business of franchising or licensing property only if, based on all the facts and circumstances, the corporation—

(*i*) Created the property; or

(*ii*) Performed significant services or incurred substantial costs with respect to the development or marketing of the property.

(*3*) *Copyright, mineral, oil and gas, and active business computer software royalties*. *Royalties* does not include copyright royalties, nor mineral, oil and gas royalties if the income from those royalties would not be treated as personal holding company income under

sections 543 (a)(3) and (a)(4) if the corporation were a C corporation; amounts received upon disposal of timber, coal, or domestic iron ore with respect to which the special rules of sections 631 (b) and (c) apply; and active business computer software royalties as defined under section 543(d) (without regard to paragraph (d)(5) of section 543).

(B) *Rents*—(*1*) *In general*. *Rents* means amounts received for the use of, or right to use, property (whether real or personal) of the corporation.

(*2*) *Rents derived in the active trade or business of renting property*. *Rents* does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

(*3*) *Produced film rents*. *Rents* does not include produced film rents as defined under section 543(a)(5).

(*4*) *Income from leasing self-produced tangible property*. *Rents* does not include compensation, however designated, for the use of, or right to use, any real or tangible personal property developed, manufactured, or produced by the taxpayer, if during the taxable year the taxpayer is engaged in substantial development, manufacturing, or production of real or tangible personal property of the same type.

(C) *Dividends*. *Dividends* includes dividends as defined in section 316, amounts to be included in gross income under section 551 (relating to foreign personal holding company income taxed to U.S. shareholders), and consent dividends as provided in section 565. See paragraphs (c)(5)(iii) (B) and (C) of this section for special rules for the treatment of certain dividends and certain payments to a patron of a cooperative. See §1.1362–8 for special rules regarding the treatment of dividends received by an S corporation from a C corporation in which the S corporation holds stock meeting the requirements of section 1504(a)(2).

(D) *Interest*—(*1*) *In general*. *Interest* means any amount received for the use of money (including tax-exempt interest and amounts treated as interest under section 483, 1272, 1274, or 7872). See paragraph (c)(5)(iii)(B) of this section for a special rule for the treatment of interest derived in certain businesses.

(*2*) *Interest on obligations acquired in the ordinary course of a trade or business*. *Interest* does not include interest on any obligation acquired from the sale of property described in section 1221(1) or the performance of services in the ordinary course of a trade or business of selling the property or performing the services.

(E) *Annuities*. *Annuities* means the entire amount received as an annuity under an annuity, endowment, or life insurance contract, if any part of the amount would be includible in gross income under section 72.

(F) *Gross receipts from the sale of stock or securities*. Gross receipts from the sales or exchanges of stock or securities, as described in paragraph (c)(4)(ii)(B) of this section, are passive investment income to the extent of gains therefrom. See paragraph (c)(5)(iii)(B) of this section for a special rule for the treatment of gains derived in certain businesses.

(G) *Identified income*. *Passive investment income* does not include income identified by the Commissioner by regulations, revenue ruling, or revenue procedure as income derived in the ordinary course of a trade or business for purposes of this section.

(iii) *Special rules*. For purposes of this paragraph (c)(5), the following special rules apply:

(A) *Options or commodities dealers*. In the case of an options dealer or commodities dealer, *passive investment income* does not include any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section

1256 contracts) from any section 1256 contract or property related to the contract. *Options dealer*, *commodities dealer*, and *section 1256 contract* have the same meaning as in section 1362(d)(3)(E)(ii).

(B) *Treatment of certain lending, financing and other business—(1) In general. Passive investment income* does not include gross receipts that are directly derived in the ordinary course of a trade or business of—

(*i*) Lending or financing;

(*ii*) Dealing in property;

(*iii*) Purchasing or discounting accounts receivable, notes, or installment obligations; or

(*iv*) Servicing mortgages.

(*2*) *Directly derived*. For purposes of this paragraph (c)(5)(iii)(B), gross receipts directly derived in the ordinary course of business includes gain (as well as interest income) with respect to loans originated in a lending business, or interest income (as well as gain) from debt obligations of a dealer in such obligations. However, interest earned from the investment of idle funds in short-term securities does not constitute gross receipts directly derived in the ordinary course of business. Similarly, a dealer's income or gain from an item of property is not directly derived in the ordinary course of its trade or business if the dealer held the property for investment at any time before the income or gain is recognized.

(C) *Payment to a patron of a cooperative. Passive investment income* does not include amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2) (A) or (C) of section 1381(a)) by reason of any payment or allocation to the patron based on patronage occurring in the case of a trade or business of the patron.

(6) *Examples*. The principles of paragraphs (c)(4) and (c)(5) of this section are illustrated by the following examples. Unless otherwise provided in an example, *S* is an S corporation with subchapter C earnings and profits, and *S*'s gross receipts from operations are gross receipts not derived from royalties, rents, dividends, interest, annuities, or gains from the sales or exchanges of stock or securities. *S* is a calendar year taxpayer and its first taxable year as an S corporation is 1993.

Example 1. Sales of capital assets, stock and securities. (i) *S* uses an accrual method of accounting and sells:

(1) A depreciable asset, held for more than 6 months, which is used in the corporation's business;

(2) A capital asset (other than stock or securities) for a gain;

(3) A capital asset (other than stock or securities) for a loss; and

(4) Securities.

S receives payment for each asset partly in money and partly in the form of a note payable at a future time, and elects not to report the sales on the installment method.

(ii) The amount of money and the face amount (or issue price if different) of the note received for the business asset are considered gross receipts in the taxable year of sale and are not reduced by the adjusted basis of the property, costs of sale, or any other amount. With respect to the sales of the capital assets, gross receipts include the cash down payment and face amount (or issue price if different) of any notes, but only to the extent of *S*'s capital gain net income. In the case of the sale of the securities, gross receipts include the cash down payment and face amount (or issue price if different) of the notes, but only to the extent of gain on the sale. In determining gross receipts from sales of securities, losses are not netted against gains.

Example 2. Long-term contract reported on percentage-of-completion method. S has a long-term contract as defined in §1.460–1(b)(1) with respect to which it reports income according to the percentage-of-completion method as described in §1.460–4(b). The portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year is included in *S*'s gross receipts for the year.

Example 3. Income reported on installment sale method. For its 1993 taxable year, S sells personal property on the installment plan and elects to report its taxable income from the sale of the property (other than property qualifying as a capital asset or stock or securities) on the installment method in accordance with section 453. The installment payment actually received in a given taxable year of S is included in gross receipts for the year.

Example 4. Partnership interests. In 1993, S and two of its shareholders contribute cash to form a general partnership, PRS. S receives a 50 percent interest in the capital and profits of PRS. S formed PRS to indirectly invest in marketable stocks and securities.

The only assets of PRS are the stock and securities, and certain real and tangible personal property. In 1994, S needs cash in its business and sells its partnership interest at a gain rather than having PRS sell the marketable stock or securities that have appreciated. Under paragraph (c)(4)(ii)(B)(*4*) of this section, the gain on S's disposition of its interest is PRS is treated as gain from the sale or exchange of stock or securities to the extent of the amount the distributive share of gain S would have received from the sale of stock or securities held by PRS if PRS had sold all of its stock or securities at fair market value at the time S disposed of its interest in PRS.

Example 5. Royalties derived in ordinary course of trade or business. (i) In 1993, S has gross receipts of $75,000. Of this amount, $5,000 is from royalty payments with respect to Trademark A, $8,000 is from royalty payments with respect to Trademark B, and $62,000 is gross receipts from operations. S created Trademark A, but S did not create Trademark B or perform significant services or incur substantial costs with respect to the development or marketing of Trademark B.

(ii) Because S created Trademark A, the royalty payments with respect to Trademark A are derived in the ordinary course of S's business and are not included within the definition of *royalties* for purposes of determining S's passive investment income. However, the royalty payments with respect to Trademark B are included within the definition of *royalties* for purposes of determining S's passive investment income. See paragraph (c)(5)(ii)(A) of this section. S's passive investment income for the year is $8,000, and S's passive investment income percentage for the taxable year is 10.67% ($8,000/$75,000). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

Example 6. Dividends; gain on sale of stock derived in the ordinary course of trade or business. (i) In 1993, S receives dividends of $10,000 on stock of corporations P and O, recognizes a gain of $25,000 on sale of the P stock, and recognizes a loss of $12,000 on sale of the O stock. S held the P and O stock for investment, rather than for sale in the ordinary course of a trade or business. S has gross receipts from operations and from gain on the sale of stock in the ordinary course of its trade or business of $110,000.

(ii) S's gross receipts are calculated as follows:

$110,000	Gross receipts from operations and from gain on the sale of stock in the ordinary course of a trade or business
10,000	Gross dividend receipts
25,000	Gain on sale of P stock (Loss on O stock not taken into account
145,000	Total gross receipts

(iii) S's passive investment income is determined as follows:

$10,000	Gross dividend receipts
25,000	Gain on sale of P stock (Loss on O stock not taken into account
35,000	Total passive investment income

(iv) S's passive investment income percentage for its first year as an S corporation is 24.1% ($35,000/$145,000). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

Example 7. Interest on accounts receivable; netting of gain on sale of real property investments. (i) In 1993, S receives $6,000 of interest on accounts receivable arising from S's sales of inventory property. S also received dividends with respect to stock held for investment of $1,500. In addition, *S* sells two parcels of real property (Property J and Property K) that S had purchased and held for investment. S sells Property J, in which S has a basis of $5,000, for $10,000 (a gain of $5,000). S sells Property K, in which S has a basis of $12,000, for $9,000 (a loss of $3,000). S has gross receipts from operations of $90,000.

(ii) S's gross receipts are calculated as follows:

$90,000	Gross receipts from operations
6,000	Gross interest receipts
1,500	Gross dividend receipts
2,000	Net gain on sale of real property investments
$99,500	Total gross receipts

(iii) Under paragraph (c)(5)(ii)(D) of this section, S's gross interest receipts are not passive investment income. In addition, gain on the sale of real property ($2,000) is not passive investment income. S's passive investment income includes only the $1,500 of gross dividend receipts. Accordingly, S's passive investment income percentage for its first year as an S corporation is 1.51% ($1,500/$99,500). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

Example 8. Interest received in the ordinary course of a lending business. (i) In 1993, S has gross receipts of $100,000 from loans and investments made in the ordinary course of S's mortgage banking business. This includes, for example, mortgage servicing fees, interest earned on mortgages prior to sale of the mortgages, and gain on sale of mortgages. In addition, S receives, from the investment of idle funds in short-term securities, $15,000 of gross interest income and $5,000 of gain.

(ii) S's gross receipts are calculated as follows:

$100,000	Gross receipts from operations
15,000	Gross interest receipts
5,000	Gain on sale of securities
120,000	Total gross receipts

(iii) *S*'s passive investment income is determined as follows:

$15,000	Gross interest receipts
5,000	Gain on sale of securities,
20,000	Total passive investment income

(iv) S's passive investment income percentage for its first year as an S corporation is 16.67% ($20,000/$120,000). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

[T.D. 8449, 57 FR 55449, Nov. 25, 1992; 58 FR 15274, Mar. 22, 1993, as amended by T.D. 8869, 65 FR 3854, Jan. 25, 2000; T.D. 8995, 67 FR 34610, May 15, 2002; T.D. 9914, 85 FR 66478, Oct. 20, 2020]

§ 1.1362–3 Treatment of S termination year.

(a) *In general*. If an S election terminates under section 1362(d) on a date other than the first day of a taxable year of the corporation, the corporation's taxable year in which the termination occurs is an S termination year. The portion of the S termination year ending at the close of the day prior to the termination is treated as a short taxable year for which the corporation is an S corporation (the *S short year*). The portion of the S termination year beginning on the day the termination is effective is treated as a short taxable year for which the corporation is a C corporation (the *C short year*). Except as provided in paragraphs (b) and (c)(1) of this section, the corporation allocates income or loss for the entire year on a pro rata basis as described in section 1362(e)(2). To the extent that income or loss is not allocated on a pro rata basis under this section, items of income, gain, loss, deduction, and credit are assigned to each short taxable year on the basis of the corporation's normal method of accounting as determined under section 446. See, however, § 1.1502–76(b)(1)(ii)(A)(*2*) for special rules for an S election that terminates under section 1362(d) immediately before the S corporation becomes a member of a consolidated group (within the meaning of § 1.1502–1(h)). See § 1.460–4(k)(3)(iv)(D) for rules relating to the computation of the S corporation's income or loss from a contract accounted for under a long-term contract method of accounting in the S termination year.

(b) *Allocations other than pro rata*—(1) *Elections under section 1362(e)(3)*. The pro rata allocation rules of section 1362(e)(2) do not apply if the corporation elects to allocate its S termination year income on the basis of its normal tax accounting method. This election may be made only with the consent of each person who is a shareholder in the corporation at any time during the S short year and of each person who is a shareholder in the corporation on the first day of the C short year. See § 1.1362–6(a) for rules concerning the time and manner of making this election.

(2) *Purchase of stock treated as an asset purchase*. The pro rata allocation rules of section 1362(e)(2) do not apply with respect to any item resulting from the application of section 338.

(3) *50 percent change in ownership during S termination year*. The pro rata allocation rules of section 1362(e)(2) do not apply if at any time during the S termination year, as a result of sales or exchanges of stock in the corporation during that year, there is a change in ownership of 50 percent or more of the issued and outstanding shares of stock of the corporation. If stock has already been sold or exchanged during the S termination year, subsequent sales or exchanges of that stock are not taken into account for purposes of this paragraph (b)(3).

(c) *Special rules*—(1) *S corporation that is a partner in a partnership*. For purposes of section 706(c) only, the termination of the election of an S corporation that is a partner in a partnership during any portion of the S short year under § 1.1362–2 (a) or (b), is treated as a sale or exchange of the corporation's entire interest in the partnership on the last day of the S short year, if—

(i) The pro rata allocation rules do not apply to the corporation; and

(ii) Any taxable year of the partnership ends with or within the C short year.

(2) *Tax for the C short year*. The taxable income for the C short year is determined on an annualized basis as described in section 1362(e)(5).

(3) *Each short year treated as taxable year*—(i) *In general*. Except as otherwise

provided in paragraph (c)(4) of this section, the S and C short years are treated as two separate years for purposes of all provisions of the Internal Revenue Code.

(ii) *Application of section 163(j).* For purposes of section 163(j), a separate limitation (as defined in §1.163(j)–1(b)(36)) applies to each S short year and each C short year. Any items necessary to determine the amount of business interest expense (as defined in §1.163(j)–1(b)(3)) that are deducted in each S short year or C short year must be allocated between the S short year and C short year in accordance with an allocation methodology provided in section 1362(e).

(4) *Year for carryover purposes.* The S and C short years are treated as one year for purposes of determining the number of taxable years to which any item may be carried back or forward by the corporation.

(5) *Due date for S short year return.* The date by which the return for the S short year must be filed is the same as the date by which the return for the C short year must be filed (including extensions).

(6) *Year in which income from S short year is includible.* A shareholder must include in taxable income the shareholder's pro rata share of the items described in section 1366(a) for the S short year for the taxable year with or within which the S termination year ends.

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

(1) *Example 1.* S termination year not created.

(i) On January 1, 1993, the first day of its taxable year, a subchapter C corporation had three eligible shareholders. During 1993, the corporation properly elected to be treated as an S corporation effective January 1, 1994, the first day of the succeeding taxable year. Subsequently, a transfer of some of the stock in the corporation was made to an ineligible shareholder. The ineligible shareholder still holds the stock on January 1, 1994.

(ii) The corporation fails to meet the definition of a small business corporation on January 1, 1994, and its election is treated as having terminated on that date. See §1.1362–2(b)(2) for the termination rules. Because the corporation ceases to be a small business corporation on the first day of a taxable year, an S termination year is not created. In addition, if the corporation in the future meets the definition of a small business corporation and desires to elect to be treated as an S corporation, the corporation is automatically granted consent to reelect before the expiration of the 5-year waiting period. See §1.1362–5 for special rules concerning automatic consent to reelect.

(2) *Example 2.* More than 50 percent change in ownership during S short year.

A, an individual, owns all 100 outstanding shares of stock of S, a calendar year S corporation. On January 31, 1993, A sells 60 shares of S stock to B, an individual. On June 1, 1993, A sells 5 shares of S stock to PRS, a partnership. S ceases to be a small business corporation on June 1, 1993, and pursuant to section 1362(d)(2), its election terminates on that date. Because there was a more than 50 percent change in ownership of the issued and outstanding shares of S stock, S must assign the items of income, loss, deduction, or credit for the S termination year to the two short taxable years on the basis of S's normal method of accounting under the rules of paragraph (b)(3) of this section.

(3) *Example 3.* More than 50 percent change in ownership during C short year.

A, an individual, owns all 100 outstanding shares of stock of S, a calendar year S corporation. On June 1, 1993, A sells 5 shares of S stock to PRS, a partnership. S ceases to be a small business corporation on that date and pursuant to section 1362(d)(3), its election terminates on that date. On July 1, 1993, A sells 60 shares of S stock to B, an individual. Since there was a more than 50 percent change in ownership of the issued and outstanding shares of S stock during the S termination year, S must assign the items of income, loss, deduction, or credit for the S termination year to the two short taxable years on the basis of S's normal method of accounting under the rules of paragraph (b)(3) of this section.

(4) *Example 4.* Stock acquired other than by sale or exchange.

C and D are shareholders in S, a calendar year S corporation. Each owns 50 percent of the issued and outstanding shares of the corporation on December 31, 1993. On March 1, 1994, C makes a gift of his entire shareholder interest to T, a trust not permitted as a shareholder under section 1361(c)(2). S ceases to be a small business corporation on March 1, 1994, and pursuant to section 1362(d)(2), its S corporation election terminates effective on that date. As a result of the gift, T owns 50 percent of S's issued and outstanding stock. However, because T acquired the stock by gift from C rather than by sale or exchange, there has not been a more than 50 percent change in ownership by sale or exchange of S that would cause the rules of paragraph (b)(3) of this section to apply.

[T.D. 8449, 57 FR 55452, Nov. 25, 1992, as amended by T.D. 8842, 64 FR 61205, Nov. 10, 1999; T.D. 9137, 69 FR 42559, July 16, 2004; T.D. 9905, 85 FR 56842, Sept. 14, 2020]

§ 1.1362–4 Inadvertent terminations and inadvertently invalid elections.

(a) *In general.* A corporation is treated as continuing to be an S corporation or a QSub (or, an invalid election to be either an S corporation or a QSub is treated as valid) during the period specified by the Commissioner if—

(1) The corporation made a valid election under section 1362(a) or section 1361(b)(3) and the election terminated or the corporation made an election under section 1362(a) or section 1361(b)(3) that was invalid;

(2) The Commissioner determines that the termination or invalidity was inadvertent;

(3) Within a reasonable period of time after discovery of the terminating event or invalid election, steps were taken so that the corporation for which the election was made or the termination occurred is a small business corporation or a QSub, as the case may be, or to acquire the required shareholder consents; and

(4) The corporation and shareholders agree to adjustments that the Commissioner may require for the period.

(b) *Inadvertent termination or inadvertently invalid election.* For purposes of paragraph (a) of this section, the determination of whether a termination or invalid election was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination or invalid election was inadvertent. The fact that the terminating event or invalidity of the election was not reasonably within the control of the corporation and, in the case of a termination, was not part of a plan to terminate the election, or the fact that the terminating event or circumstance took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event or circumstance, tends to establish that the termination or invalidity of the election was inadvertent.

(c) *Corporation's request for determination of an inadvertent termination or invalid election.* A corporation that believes that the termination or invalidity of its election was inadvertent may request a determination from the Commissioner that the termination or invalidity of its election was inadvertent. The request is made in the form of a ruling request and should set forth all relevant facts pertaining to the event or circumstance including, but not limited to, the facts described in paragraph (b) of this section, the date of the corporation's election (or intended election) under section 1362(a) or 1361(b)(3), a detailed explanation of the event or circumstance causing the termination or invalidity, when and how the event or circumstance was discovered, and the steps taken under paragraph (a)(3) of this section.

(d) *Adjustments.* The Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation or QSub during the period specified by the Commissioner. In the case of stock held by an ineligible shareholder that causes an inadvertent termination or invalid election for an S corporation under section 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of the S corporation

during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent the loss of any revenue due to the holding of stock by an ineligible shareholder (for example, a nonresident alien).

(e) *Corporation and shareholder consents.* The corporation and all persons who were shareholders of the corporation at any time during the period specified by the Commissioner must consent to any adjustments that the Commissioner may require. Each consent should be in the form of a statement agreeing to make the adjustments. The statement must be signed by the shareholder (in the case of shareholder consent) or a person authorized to sign the return required by section 6037 (in the case of corporate consent). See §1.1362–6(b)(2) for persons required to sign consents. A shareholder's consent statement should include the name, address, and taxpayer identification numbers of the corporation and shareholder, the number of shares of stock owned by the shareholder, and the dates on which the shareholder owned any stock. The corporate consent statement should include the name, address, and taxpayer identification numbers of the corporation and each shareholder.

(f) *Status of corporation.* The status of the corporation after the terminating event or invalid election and before the determination of inadvertence is determined by the Commissioner. Inadvertent termination or inadvertent invalid election relief may be granted retroactively for all years for which the terminating event or circumstance giving rise to invalidity is effective, in which case the corporation is treated as if its election was valid or had not terminated. Alternatively, relief may be granted only for the period in which the corporation became eligible for subchapter S or QSub treatment, in which case the corporation is treated as a C corporation or, in the case of a QSub with an inadvertently terminated or invalid election, as a separate C corporation, during the period for which the corporation was not eligible for its intended status.

(g) *Effective/applicability date.* Paragraphs (a), (b), (c), (d), and (f) of this section are effective on *August 14, 2008.*

[T.D. 8449, 57 FR 55453, Nov. 25, 1992, as amended by T.D. 9422, 73 FR 47530, Aug. 14, 2008]

§1.1362–5 Election after termination.

(a) *In general.* Absent the Commissioner's consent, an S corporation whose election has terminated (or a successor corporation) may not make a new election under section 1362(a) for five taxable years as described in section 1362(g). However, the Commissioner may permit the corporation to make a new election before the 5-year period expires. The corporation has the burden of establishing that under the relevant facts and circumstances, the Commissioner should consent to a new election. The fact that more than 50 percent of the stock in the corporation is owned by persons who did not own any stock in the corporation on the date of the termination tends to establish that consent should be granted. In the absence of this fact, consent ordinarily is denied unless the corporation shows that the event causing termination was not reasonably within the control of the corporation or shareholders having a substantial interest in the corporation and was not part of a plan on the part of the corporation or of such shareholders to terminate the election.

(b) *Successor corporation.* A corporation is a *successor corporation* to a corporation whose election under section 1362 has been terminated if—

(1) 50 percent or more of the stock of the corporation (the new corporation) is owned, directly or indirectly, by the same persons who, on the date of the termination, owned 50 percent or more of the stock of the corporation whose election terminated (the old corporation); and

(2) Either the new corporation acquires a substantial portion of the assets of the old corporation, or a substantial portion of the assets of the new corporation were assets of the old corporation.

(c) *Automatic consent after certain terminations.* A corporation may, without

requesting the Commissioner's consent, make a new election under section 1362(a) before the 5-year period described in section 1362(g) expires if the termination occurred because the corporation—

(1) Revoked its election effective on the first day of the first taxable year for which its election was to be effective (see § 1.1362–2(a)(2)); or

(2) Failed to meet the definition of a small business corporation on the first day of the first taxable year for which its election was to be effective (see § 1.1362–2(b)(2)).

[T.D. 8449, 57 FR 55454, Nov. 25, 1992]

§ 1.1362–6 Elections and consents.

(a) *Time and manner of making elections*—(1) *In general.* An election statement made under this section must identify the election being made, set forth the name, address, and taxpayer identification number of the corporation, and be signed by a person authorized to sign the return required to be filed under section 6037.

(2) *Election to be an S corporation*—(i) *Manner of making election.* A small business corporation makes an election under section 1362(a) to be an S corporation by filing a completed Form 2553. The election form must be filed with the service center designated in the instructions applicable to Form 2553. The election is not valid unless all shareholders of the corporation at the time of the election consent to the election in the manner provided in paragraph (b) of this section. However, once a valid election is made, new shareholders need not consent to that election.

(ii) *Time of making election*—(A) *In general.* The election described in paragraph (a)(2)(i) of this section may be made by a small business corporation at any time during the taxable year that immediately precedes the taxable year for which the election is to be effective, or during the taxable year for which the election is to be effective provided that the election is made before the 16th day of the third month of the year. If a corporation makes an election for a taxable year, and the election meets all the requirements of this section but is made during the period beginning after the 15th day of the third month of the taxable year, the election is treated as being made for the following taxable year provided that the corporation meets all the requirements of section 1361(b) at the time the election is made. For taxable years of 2½ months or less, an election made before the 16th day of the third month after the first day of the taxable year is treated as made during that year.

(B) *Elections made during the first 2½ months treated as made for the following taxable year.* A timely election made by a small business corporation during the taxable year for which it is intended to be effective is nonetheless treated as made for the following taxable year if—

(*1*) The corporation is not a small business corporation during the entire portion of the taxable year which occurs before the date the election is made; or

(*2*) Any person who held stock in the corporation at any time during the portion of the taxable year which occurs before the time the election is made, and who does not hold stock at the time the election is made, does not consent to the election.

(C) *Definition of month and beginning of the taxable year. Month* means a period commencing on the same numerical day of any calendar month as the day of the calendar month on which the taxable year began and ending with the close of the day preceding the numerically corresponding day of the succeeding calendar month or, if there is no corresponding day, with the close of the last day of the succeeding calendar month. In addition, the taxable year of a new corporation begins on the date that the corporation has shareholders, acquires assets, or begins doing business, whichever is the first to occur. The existence of incorporators does not necessarily begin the taxable year of a new corporation.

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

Example 1. Effective election; no prior taxable year. A calendar year small business corporation begins its first taxable year on January 7, 1993. To be an S corporation beginning with its first taxable year, the corporation

must make the election set forth in this section during the period that begins January 7, 1993, and ends before March 22, 1993. Because the corporation had no taxable year immediately preceding the taxable year for which the election is to be effective, an election made earlier than January 7, 1993, will not be valid.

Example 2. Effective election; taxable year less than 2 ½ months. A calendar year small business corporation begins its first taxable year on November 8, 1993. To be an S corporation beginning with its first taxable year, the corporation must make the election set forth in this section during the period that begins November 8, 1993, and ends before January 23, 1994.

Example 3. Election effective for the following taxable year; ineligible shareholder. On January 1, 1993, two individuals and a partnership own all of the stock of a calendar year subchapter C corporation. On January 31, 1993, the partnership dissolved and distributed its shares in the corporation to its five partners, all individuals. On February 28, 1993, the seven shareholders of the corporation consented to the corporation's election of subchapter S status. The corporation files a properly completed Form 2533 on March 2, 1993. The corporation is not eligible to be a subchapter S corporation for the 1993 taxable year because during the period of the taxable year prior to the election it had an ineligible shareholder. However, under paragraph (a)(2)(ii)(B) of this section, the election is treated as made for the corporation's 1994 taxable year.

(3) *Revocation of S election*—(i) *Manner of revoking election.* To revoke an election, the corporation files a statement that the corporation revokes the election made under section 1362(a). The statement must be filed with the service center where the election was properly filed. The revocation statement must include the number of shares of stock (including non-voting stock) issued and outstanding at the time the revocation is made. A revocation may be made only with the consent of shareholders who, at the time the revocation is made, hold more than one-half of the number of issued and outstanding shares of stock (including non-voting stock) of the corporation. Each shareholder who consents to the revocation must consent in the manner required under paragraph (b) of this section. In addition, each consent should indicate the number of issued and outstanding shares of stock (including non-voting stock) held by each shareholder at the time of the revocation.

(ii) *Time of revoking election.* For rules concerning when a revocation is effective, see §1.1362–2(a)(2).

(iii) *Examples.* The principles of this paragraph (a)(3) are illustrated by the following examples:

Example 1. Revocation; consent of shareholders owning more than one-half of issued and outstanding shares. A calendar year S corporation has issued an outstanding 40,000 shares of class A voting common stock and 20,000 shares of class B non-voting common stock. The corporation wishes to revoke its election of subchapter S status. Shareholders owning 11,000 shares of class A stock sign revocation consents. Shareholders owning 20,000 shares of class B stock sign revocation consents. The corporation has obtained the required shareholder consent to revoke its subchapter S election because shareholders owning more than one-half of the total number of issued and outstanding shares of stock of the corporation consented to the revocation.

Example 2. Effective prospective revocation. In June 1993, a calendar year S corporation determines that it will revoke its subchapter S election effective August 1, 1993. To do so it must file its revocation statement with consents attached on or before August 1, 1993, and the statement must indicate that the revocation is intended to be effective August 1, 1993.

(4) *Rescission of revocation*—(i) *Manner of rescinding a revocation.* To rescind a revocation, the corporation files a statement that the corporation rescinds the revocation made under section 1362(d)(1). The statement must be filed with the service center where the revocation was properly filed. A rescission may be made only with the consent (in the manner required under paragraph (b)(1) of this section) of each person who consented to the revocation and of each person who became a shareholder of the corporation within the period beginning on the first day after the date the revocation was made and ending on the date on which the rescission is made.

(ii) *Time of rescinding a revocation.* If the rescission statement is filed before the revocation becomes effective and is filed with proper service center, the rescission is effective on the date it is so filed.

(5) *Election not to apply pro rata allocation.* To elect not to apply the pro

rata allocation rules to an S termination year, a corporation files a statement that it elects under section 1362(e)(3) not to apply the rules provided in section 1362(e)(2). In addition to meeting the requirements of paragraph (a)(1) of this section, the statement must set forth the cause of the termination and the date thereof. The statement must be filed with the corporation's return for the C short year. This election may be made only with the consent of all persons who are shareholders of the corporation at any time during the S short year and all persons who are shareholders of the corporation on the first day of the C short year (in the manner required under paragraph (b)(1) of this section).

(b) *Shareholders' consents*—(1) *Manner of consents in general.* A shareholder's consent required under paragraph (a) of this section must be in the form of a written statement that sets forth the name, address, and taxpayer identification number of the shareholder, the number of shares of stock owned by the shareholder, the date (or dates) on which the stock was acquired, the date on which the shareholder's taxable year ends, the name of the S corporation, the corporation's taxpayer identification number, and the election to which the shareholder consents. The statement must be signed by the shareholder under penalties of perjury. Except as provided in paragraph (b)(3)(iii) of this section, the election of the corporation is not valid if any required consent is not filed in accordance with the rules contained in this paragraph (b). The consent statement should be attached to the corporation's election statement.

(2) *Persons required to consent.* The following rules apply in determining persons required to consent:

(i) *Community interest in stock.* When stock of the corporation is owned by husband and wife as community property (or the income from the stock is community property), or is owned by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in the stock or income therefrom and each tenant in common, joint tenant and tenant by the entirety must consent to the election.

(ii) *Minor.* The consent of a minor must be made by the minor or by the legal representative of the minor (or by a natural or an adoptive parent of the minor if no legal representative has been appointed).

(iii) *Estate.* The consent of an estate must be made by an executor or administrator thereof, or by any other fiduciary appointed by testamentary instrument or appointed by the court having jurisdiction over the administration of the estate.

(iv) *Trusts.* In the case of a trust described in section 1361(c)(2)(A) (including a trust treated under section 1361(d)(1)(A) as a trust described in section 1361(c)(2)(A)(i) and excepting an electing small business trust described in section 1361(c)(2)(A)(v) (ESBT)), only the person treated as the shareholder for purposes of section 1361(b)(1) must consent to the election. When stock of the corporation is held by a trust, both husband and wife must consent to any election if the husband and wife have a community interest in the trust property. See paragraph (b)(2)(i) of this section for rules concerning community interests in S corporation stock. In the case of an ESBT, the trustee and the owner of any portion of the trust that consists of the stock in one or more S corporations under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code must consent to the S corporation election. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must consent to the S corporation election.

(3) *Special rules for consent of shareholder to election to be an S corporation*—(i) *In general.* The consent of a shareholder to an election by a small business corporation under section 1362(a) may be made on Form 2553 or on a separate statement in the manner described in paragraph (b)(1) of this section. In addition, the separate statement must set forth the name, address, and taxpayer identification number of the corporation. A shareholder's consent is binding and may not be withdrawn after a valid election is made by the corporation. Each person who is a shareholder (including any person who

is treated as a shareholder under section 1361(c)(2)(B)) at the time the election is made) must consent to the election. If the election is made before the 16th day of the third month of the taxable year and is intended to be effective for that year, each person who was a shareholder (including any person who was treated as a shareholder under section 1361(c)(2)(B)) at any time during the portion of that year which occurs before the time the election is made, and who is not a shareholder at the time the election is made, must also consent to the election. If the election is to be effective for the following taxable year, no consent need be filed by any shareholder who is not a shareholder on the date of the election. Any person who is considered to be a shareholder under applicable State law solely by virtue of his or her status as an incorporator is not treated as a shareholder for purposes of this paragraph (b)(3)(i).

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

Example 1. Effective election; shareholder consents. On January 1, 1993, the first day of its taxable year, a subchapter C corporation had 15 shareholders. On January 30, 1993, two of the C corporation's shareholders, A and B, both individuals, sold their shares in the corporation to P, Q, and R, all individuals. On March 1, 1993, the corporation filed its election to be an S corporation for the 1993 taxable year. The election will be effective (assuming the other requirements of section 1361(b) are met) provided that all of the shareholders as of March 1, 1993, as well as former shareholders A and B, consent to the election.

Example 2. Consent of new shareholder unnecessary. On January 1, 1993, three individuals own all of the stock of a calendar year subchapter C corporation. On April 15, 1993, the corporation, in accordance with paragraph (a)(2) of this section, files a properly completed Form 2553. The corporation anticipates that the election will be effective beginning January 1, 1994, the first day of the succeeding taxable year. On October 1, 1993, the three shareholders collectively sell 75% of their shares in the corporation to another individual. On January 1, 1994, the corporation's shareholders are the three original individuals and the new shareholder. Because the election was valid and binding when made, it is not necessary for the new shareholder to consent to the election. The corporation's subchapter S election is effective on January 1, 1994 (assuming the other requirements of section 1361(b) are met).

(iii) *Extension of time for filing consents to an election*—(A) *In general*. An election that is timely filed for any taxable year and that would be valid except for the failure of any shareholder to file a timely consent is not invalid if consents are filed as required under paragraph (b)(3)(iii)(B) of this section and it is shown to the satisfaction of the district director or director of the service center with which the corporation files its income tax return that—

(*1*) There was reasonable cause for the failure to file the consent;

(*2*) The request for the extension of time to file a consent is made within a reasonable time under the circumstances; and

(*3*) The interests of the Government will not be jeopardized by treating the election as valid.

(B) *Required consents*. Consents must be filed within the extended period of time as may be granted by the Internal Revenue Service, by all persons who—

(*1*) Were shareholders of the corporation at any time during the period beginning as of the date of the invalid election and ending on the date on which an extension of time is granted in accordance with this paragraph (b)(3)(iii); and

(*2*) Have not previously consented to the election.

[T.D. 8449, 57 FR 55454, Nov. 25, 1992, as amended by T.D. 8994, 67 FR 34400, May 14, 2002]

§ 1.1362–7 Effective dates.

(a) *In general*. The provisions of §§ 1.1362–1 through 1.1362–6 apply to taxable years of corporations beginning after December 31, 1992. For taxable years to which these regulations do not apply, corporations and shareholders subject to the provisions of section 1362 must take reasonable return positions taking into consideration the statute; its legislative history; the provisions of §§ 18.1362–1 through 18.1362–5 (see 26 CFR part 18 as contained in the CFR edition revised as of April 1, 1992). In addition, following these regulations is a reasonable return position. See Notice 92–56, 1992–49 I.R.B. (see § 601.601(d)(2)(ii)(*b*) of this chapter), for additional guidance

regarding reasonable return positions for years to which §§ 1.362–1 through 1.1362–6 do not apply. Section 1.1362–6(b)(2)(iv) is applicable for taxable years beginning on and after May 14, 2002.

(b) *Special effective date for passive investment income provisions.* For taxable years of an S corporation and all affected shareholders that are not closed, the S corporation and all affected shareholders may elect to apply the provisions of § 1.1362–2(c)(5). To make the election, the corporation and all affected shareholders must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made and each subsequent taxable year. For purposes of this section, *affected shareholders* means all shareholders who received distributive shares of S corporation items in the taxable year for which the election is made and all shareholders of the S corporation for all subsequent taxable years. However, the Commissioner may, in appropriate circumstances, permit taxpayers to make this election even if all affected shareholders cannot file consistent returns.

[T.D. 8449, 57 FR 55456, Nov. 25, 1992, as amended by T.D. 8994, 67 FR 34401, May 14, 2002]

§ 1.1362–8 Dividends received from affiliated subsidiaries.

(a) *In general.* For purposes of section 1362(d)(3), if an S corporation holds stock in a C corporation meeting the requirements of section 1504(a)(2), the term *passive investment income* does not include dividends from the C corporation to the extent those dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business (active earnings and profits). For purposes of applying section 1362(d)(3), earnings and profits of a C corporation are active earnings and profits to the extent that the earnings and profits are derived from activities that would not produce passive investment income (as defined in section 1362(d)(3)) if the C corporation were an S corporation.

(b) *Determination of active or passive earnings and profits*—(1) *In general.* An S corporation may use any reasonable method to determine the amount of dividends that are not treated as passive investment income under section 1362(d)(3)(E). Paragraph (b)(5) of this section describes a method of determining the amount of dividends that are not treated as passive investment income under section 1362(d)(3)(E) that is deemed to be reasonable under all circumstances.

(2) *Lower tier subsidiaries.* If a C corporation subsidiary (upper tier corporation) holds stock in another C corporation (lower tier subsidiary) meeting the requirements of section 1504(a)(2), the upper tier corporation's gross receipts attributable to a dividend from the lower tier subsidiary are considered to be derived from the active conduct of a trade or business to the extent the lower tier subsidiary's earnings and profits are attributable to the active conduct of a trade or business by the subsidiary under paragraph (b) (1), (3), (4), or (5) of this section. For purposes of this section, distributions by the lower tier subsidiary will be considered attributable to active earnings and profits according to the rule in paragraph (c) of this section. This paragraph (b)(2) does not apply to any member of a consolidated group (as defined in § 1.1502–1(h)).

(3) *De minimis exception.* If less than 10 percent of a C corporation's earnings and profits for a taxable year are derived from activities that would produce passive investment income if the C corporation were an S corporation, all earnings and profits produced by the corporation during that taxable year are considered active earnings and profits.

(4) *Special rules for earnings and profits accumulated by a C corporation prior to 80 percent acquisition.* A C corporation may treat all earnings and profits accumulated by the corporation in all taxable years ending before the S corporation held stock meeting the requirements of section 1504(a)(2) as active earnings and profits in the same proportion as the C corporation's active earnings and profits for the three taxable years ending prior to the time when the S corporation acquired 80 percent of the C corporation bears to the C corporation's total earnings and profits for those three taxable years.

(5) *Gross receipts safe harbor.* A corporation may treat its earnings and profits for a year as active earnings and profits in the same proportion as the corporation's gross receipts (as defined in § 1.1362–2(c)(4)) derived from activities that would not produce passive investment income (if the C corporation were an S corporation), including those that do not produce passive investment income under paragraphs (b)(2) through (b)(4) of this section, bear to the corporation's total gross receipts for the year in which the earnings and profits are produced.

(c) *Allocating distributions to active or passive earnings and profits*—(1) *Distributions from current earnings and profits.* Dividends distributed by a C corporation from current earnings and profits are attributable to active earnings and profits in the same proportion as current active earnings and profits bear to total current earnings and profits of the C corporation.

(2) *Distributions from accumulated earnings and profits.* Dividends distributed by a C corporation out of accumulated earnings and profits for a taxable year are attributable to active earnings and profits in the same proportion as accumulated active earnings and profits for that taxable year bear to total accumulated earnings and profits for that taxable year immediately prior to the distribution.

(3) *Adjustments to active earnings and profits.* For purposes of applying paragraph (c) (1) or (2) of this section to a distribution, the active earnings and profits of a corporation shall be reduced by the amount of any prior distribution properly treated as attributable to active earnings and profits from the same taxable year.

(4) *Special rules for consolidated groups.* For purposes of applying section 1362(d)(3) and this section to dividends received by an S corporation from the common parent of a consolidated group (as defined in § 1.1502–1(h)), the following rules apply—

(i) The current earnings and profits, accumulated earnings and profits, and active earnings and profits of the common parent shall be determined under the principles of § 1.1502–33 (relating to earnings and profits of any member of a consolidated group owning stock of another member); and

(ii) The gross receipts of the common parent shall be the sum of the gross receipts of each member of the consolidated group (including the common parent), adjusted to eliminate gross receipts from intercompany transactions (as defined in § 1.1502–13(b)(1)(i)).

(d) *Examples.* The following examples illustrate the principles of this section:

Example 1. (i) X, an S corporation, owns 85 percent of the one class of stock of Y. On December 31, 2002, Y declares a dividend of $100 ($85 to X), which is equal to Y's current earnings and profits. In 2002, Y has total gross receipts of $1,000, $200 of which would be passive investment income if Y were an S corporation.

(ii) One-fifth ($200/$1,000) of Y's gross receipts for 2002 is attributable to activities that would produce passive investment income. Accordingly, one-fifth of the $100 of earnings and profits is passive, and $17 (⅕ of $85) of the dividend from Y to X is passive investment income.

Example 2. (i) The facts are the same as in *Example 1*, except that Y owns 90 percent of the stock of Z. Y and Z do not join in the filing of a consolidated return. In 2002, Z has gross receipts of $15,000, $12,000 of which are derived from activities that would produce passive investment income. On December 31, 2002, Z declares a dividend of $1,000 ($900 to Y) from current earnings and profits.

(ii) Four-fifths ($12,000/$15,000) of the dividend from Z to Y are attributable to passive earnings and profits. Accordingly, $720 (⅘ of $900) of the dividend from Z to Y is considered gross receipts from an activity that would produce passive investment income. The $900 dividend to Y gives Y a total of $1,900 ($1,000 + $900) in gross receipts, $920 ($200 + $720) of which is attributable to passive investment income-producing activities. Under these facts, $41 ($920/$1,900 of $85) of Y's distribution to X is passive investment income to X.

(e) *Effective date.* This section applies to dividends received in taxable years beginning on or after January 20, 2000; however, taxpayers may elect to apply the regulations in whole, but not in part, for taxable years beginning on or after January 1, 2000, provided all affected taxpayers apply the regulations in a consistent manner. To make this election, the corporation and all affected taxpayers must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made. For

purposes of this section, affected taxpayers means all taxpayers whose returns are affected by the election to apply the regulations.

[T.D. 8869, 65 FR 3854, Jan. 25, 2000; 65 FR 16318, Mar. 28, 2000]

§ 1.1363–1 Effect of election on corporation.

(a) *Exemption of corporation from income tax*—(1) *In general.* Except as provided in this paragraph (a), a small business corporation that makes a valid election under section 1362(a) is exempt from the taxes imposed by chapter 1 of the Internal Revenue Code with respect to taxable years of the corporation for which the election is in effect.

(2) *Corporate level taxes.* An S corporation is not exempt from the tax imposed by section 1374 (relating to the tax imposed on certain built-in gains), or section 1375 (relating to the tax on excess passive investment income). See also section 1363(d) (relating to the recapture of LIFO benefits) for the rules regarding the payment by an S corporation of LIFO recapture amounts.

(b) *Computation of corporate taxable income.* The taxable income of an S corporation is computed as described in section 1363(b).

(c) *Elections of the S corporation*—(1) *In general.* Any elections (other than those described in paragraph (c)(2) of this section) affecting the computation of items derived from an S corporation are made by the corporation. For example, elections of methods of accounting, of computing depreciation, of treating soil and water conservation expenditures, and the option to deduct as expenses intangible drilling and development costs, are made by the corporation and not by the shareholders separately. All corporate elections are applicable to all shareholders.

(2) *Exceptions.* (i) Each shareholder's pro rata share of expenses described in section 617 paid or accrued by the S corporation is treated according to the shareholder's method of treating those expenses, notwithstanding the treatment of the expenses by the corporation.

(ii) Each shareholder may elect to amortize that shareholder's pro rata share of any qualified expenditure described in section 59(e) paid or accrued by the S corporation.

(iii) Each shareholder's pro rata share of taxes described in section 901 paid or accrued by the S corporation to foreign countries or possessions of the United States (according to its method of treating those taxes) is treated according to the shareholder's method of treating those taxes, and each shareholder may elect to use the total amount either as a credit against tax or as a deduction from income.

(d) *Effective date.* This section applies to taxable years of corporations beginning after December 31, 1992. For taxable years to which this section does not apply, corporations and shareholders subject to the provisions of section 1363 must take reasonable return positions taking into consideration the statute, its legislative history and these regulations. See Notice 92–56, 1992–49 I.R.B. (see § 601.601(d)(2)(ii)(*b*) of this chapter), for additional guidance regarding reasonable return positions for taxable years to which this section does not apply.

[T.D. 8449, 57 FR 55456, Nov. 25, 1992]

§ 1.1363–2 Recapture of LIFO benefits.

(a) *In general.* A C corporation must include the LIFO recapture amount (as defined in section 1363(d)(3)) in its gross income—

(1) In its last taxable year as a C corporation if the corporation inventoried assets under the LIFO method for its last taxable year before its S corporation election becomes effective; or

(2) In the year of transfer by the C corporation to an S corporation of the LIFO inventory assets if paragraph (a)(1) of this section does not apply and the C corporation—

(i) Inventoried assets under the LIFO method during the taxable year of the transfer of those LIFO inventory assets; and

(ii) Transferred the LIFO inventory assets to the S corporation in a nonrecognition transaction (within the meaning of section 7701(a)(45)) in which the transferred assets constitute transferred basis property (within the meaning of section 7701(a)(43)).

(b) *LIFO inventory held indirectly through partnership.* A C corporation

must include the lookthrough LIFO recapture amount (as defined in paragraph (c)(4) of this section) in its gross income—

(1) In its last taxable year as a C corporation if, on the last day of the corporation's last taxable year before its S corporation election becomes effective, the corporation held a lookthrough partnership interest (as defined in paragraph (c)(3) of this section); or

(2) In the year of transfer by the C corporation to an S corporation of a lookthrough partnership interest if the corporation transferred its lookthrough partnership interest to the S corporation in a nonrecognition transaction (within the meaning of section 7701(a)(45)) in which the transferred interest constitutes transferred basis property (within the meaning of section 7701(a)(43)).

(c) *Definitions and special rules*—(1) *Recapture date.* In the case of a transaction described in paragraph (a)(1) or (b)(1) of this section, the recapture date is the day before the effective date of the S corporation election. In the case of a transaction described in paragraph (a)(2) or (b)(2) of this section, the recapture date is the date of the transfer of the partnership interest to the S corporation.

(2) *Determination of LIFO recapture amount.* The LIFO recapture amount shall be determined as of the end of the recapture date for transactions described in paragraph (a)(1) of this section, and as of the moment before the transfer occurs for transactions described in paragraph (a)(2) of this section.

(3) *Lookthrough partnership interest.* A partnership interest is a lookthrough partnership interest if the partnership owns (directly or indirectly through one or more partnerships) assets accounted for under the last-in, first-out (LIFO) method (LIFO inventory).

(4) *Lookthrough LIFO recapture amount*—(i) *In general.* For purposes of this section, a corporation's lookthrough LIFO recapture amount is the amount of income that would be allocated to the corporation, taking into account section 704(c) and §1.704–3, if the partnership sold all of its LIFO inventory for the inventory's FIFO value. For this purpose, the FIFO value of inventory is the inventory amount of the inventory assets under the first-in, first-out method of accounting authorized by section 471, determined in accordance with section 1363(d)(4)(C).

(ii) *Determination of lookthrough LIFO recapture amount.* Except as provided in paragraph (c)(4)(iii) of this section, the lookthrough LIFO recapture amount shall be determined as of the end of the recapture date for transactions described in paragraph (b)(1) of this section, and as of the moment before the transfer occurs for transactions described in paragraph (b)(2) of this section.

(iii) *Alternative rule.* If the partnership is not otherwise required to determine the inventory amount of the inventory using the LIFO method (the LIFO value) on the recapture date, the partnership may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year that includes the recapture date. For this purpose, the opening inventory includes inventory contributed by a partner to the partnership on or before the recapture date and excludes inventory distributed by the partnership to a partner on or before the recapture date. A partnership that applies the alternative method of this paragraph (c)(4)(iii) to calculate the lookthrough LIFO recapture amount must take into account any adjustments to the partnership's basis in its LIFO inventory that result from transactions occurring after the start of the partnership's taxable year and before the end of the recapture date. For example, the lookthrough LIFO recapture amount must be adjusted to take into account any adjustments to the basis of LIFO inventory during that period under sections 734(b), 737(c), or 751(b).

(d) *Payment of tax.* Any increase in tax caused by including the LIFO recapture amount or the lookthrough LIFO recapture amount in the gross income of the C corporation is payable in four equal installments. The C corporation must pay the first installment of

this payment by the due date of its return, determined without regard to extensions, for the last taxable year it operated as a C corporation if paragraph (a)(1) or (b)(1) of this section applies, or for the taxable year of the transfer if paragraph (a)(2) or (b)(2) of this section applies. The three succeeding installments must be paid—

(1) For a transaction described in paragraph (a)(1) or (b)(1) of this section, by the corporation that made the election under section 1362(a) to be an S corporation, on or before the due date for the corporation's returns (determined without regard to extensions) for the succeeding three taxable years; and

(2) For a transaction described in paragraph (a)(2) or (b)(2) of this section, by the transferee S corporation on or before the due date for the transferee corporation's returns (determined without regard to extensions) for the succeeding three taxable years.

(e) *Basis adjustments*—(1) *General rule*. Appropriate adjustments to the basis of inventory are to be made to reflect any amount included in income under paragraph (a) of this section.

(2) *LIFO inventory owned through a partnership*—(i) *Basis of corporation's partnership interest*. Appropriate adjustments to the basis of the corporation's lookthrough partnership interest are to be made to reflect any amount included in income under paragraph (b) of this section.

(ii) *Basis of partnership assets*. A partnership directly holding LIFO inventory that is taken into account under paragraph (b) of this section may elect to adjust the basis of that LIFO inventory. In addition, a partnership that holds, through another partnership, LIFO inventory that is taken into account under paragraph (b) of this section may elect to adjust the basis of that partnership interest. Any adjustment under this paragraph (e)(2) to the basis of inventory held by the partnership is equal to the amount of LIFO recapture attributable to the inventory. Likewise, any adjustment under this paragraph (e)(2) to the basis of a lookthrough partnership interest held by the partnership is equal to the amount of LIFO recapture attributable to the interest. A basis adjustment under this paragraph (e)(2) is treated in the same manner and has the same effect as an adjustment to the basis of partnership property under section 743(b). See § 1.743–1(j).

(3) *Election*. A partnership elects to adjust the basis of its inventory and any lookthrough partnership interest that it owns by attaching a statement to its original or amended income tax return for the first taxable year ending on or after the date of the S corporation election or transfer described in paragraph (b) of this section. This statement shall state that the partnership is electing under this paragraph (e)(3) and must include the names, addresses, and taxpayer identification numbers of any corporate partner liable for tax under paragraph (d) of this section and of the partnership, as well as the amount of the adjustment and the portion of the adjustment that is attributable to each pool of inventory or lookthrough partnership interest that is held by the partnership.

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

Example 1. (i) G is a C corporation with a taxable year ending on June 30. GH is a partnership with a calendar year taxable year. G has a 20 percent interest in GH. The remaining 80 percent interest is owned by an individual. On April 25, 2005, G contributed inventory that is LIFO inventory to GH, increasing G's interest in the partnership to 50 percent. GH holds no other LIFO inventory, and there are no other adjustments to the partnership's basis in its LIFO inventory between January 1, 2005 and the end of the recapture date. G elects to be an S corporation effective July 1, 2005. The recapture date is June 30, 2005 under paragraph (c)(1) of this section. GH elects to use the LIFO method for the inventory and determines that the FIFO and LIFO values of the opening inventory for GH's 2005 taxable year, including the inventory contributed by G, are $200 and $120, respectively.

(ii) Under paragraph (c)(4)(iii) of this section, GH is not required to determine the FIFO and LIFO values of the inventory on the recapture date. Instead, GH may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year (2005) that includes the recapture date. For this purpose, under paragraph (c)(4) of this section, the opening inventory includes the inventory contributed by G. The

amount by which the FIFO value ($200) exceeds the LIFO value ($120) in GH's opening inventory is $80. Thus, if GH sold all of its LIFO inventory for $200, it would recognize $80 of income. G's lookthrough LIFO recapture amount is $80, the amount of income that would be allocated to G, taking into account section 704(c) and § 1.704–3, if GH sold all of its LIFO inventory for the FIFO value. Under paragraph (b)(1) of this section, G must include $80 in income in its taxable year ending on June 30, 2005. Under paragraph (e)(2) of this section, G must increase its basis in its interest in GH by $80. Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, GH may elect to increase the basis (with respect to G only) of its LIFO inventory by $80.

Example 2. (i) J is a C corporation with a calendar year taxable year. JK is a partnership with a calendar year taxable year. J has a 30 percent interest in the partnership. JK owns LIFO inventory that is not section 704(c) property. J elects to be an S corporation effective January 1, 2005. The recapture date is December 31, 2004 under paragraph (c)(1) of this section. JK determines that the FIFO and LIFO values of the inventory on December 31, 2004 are $240 and $140, respectively.

(ii) The amount by which the FIFO value ($240) exceeds the LIFO value ($140) on the recapture date is $100. Thus, if JK sold all of its LIFO inventory for $240, it would recognize $100 of income. J's lookthrough LIFO recapture amount is $30, the amount of income that would be allocated to J if JK sold all of its LIFO inventory for the FIFO value (30 percent of $100). Under paragraph (b)(1) of this section, J must include $30 in income in its taxable year ending on December 31, 2004. Under paragraph (e)(2) of this section, J must increase its basis in its interest in JK by $30. Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, JK may elect to increase the basis (with respect to J only) of its inventory by $30.

(g) *Effective dates.* (1) The provisions of paragraph (a)(1) of this section apply to S elections made after December 17, 1987. For an exception, see section 10227(b)(2) of the Revenue Act of 1987.

(2) The provisions of paragraph (a)(2) of this section apply to transfers made after August 18, 1993.

(3) The provisions of paragraphs (b), (c), (d), (e)(2), (e)(3), and (f) of this section apply to S elections and transfers made on or after August 13, 2004. The rules that apply to S elections and transfers made before August 13, 2004, are contained in § 1.1363–2 as in effect prior to August 13, 2004 (see 26 CFR part 1 revised as of April 1, 2005).

[T.D. 8567, 59 FR 51106, Oct. 7, 1994, as amended by T.D. 9210, 70 FR 39921, July 12, 2005]

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§ 1.1366–4 Special rules limiting the passthrough of certain items of an S corporation to its shareholders.

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§ 1.1366–5 Effective/applicability date.

[T.D. 8852, 64 FR 71644, Dec. 22, 1999, as amended by T.D. 9422, 73 FR 47530, Aug. 14, 2008; T.D. 9682, 79 FR 42677, July 23, 2014]

§ 1.1366–1 Shareholder's share of items of an S corporation.

(a) *Determination of shareholder's tax liability*—(1) *In general.* An S corporation must report, and a shareholder is required to take into account in the shareholder's return, the shareholder's pro rata share, whether or not distributed, of the S corporation's items of income, loss, deduction, or credit described in paragraphs (a)(2), (3), and (4) of this section. A shareholder's pro rata share is determined in accordance with the provisions of section 1377(a) and the regulations thereunder. The shareholder takes these items into account in determining the shareholder's taxable income and tax liability for the shareholder's taxable year with or within which the taxable year of the corporation ends. If the shareholder dies (or if the shareholder is an estate or trust and the estate or trust terminates) before the end of the taxable year of the corporation, the shareholder's pro rata share of these items is taken into account on the shareholder's final return. For the limitation on allowance of a shareholder's pro rata share of S corporation losses or deductions, see section 1366(d) and § 1.1366–2.

(2) *Separately stated items of income, loss, deduction, or credit.* Each shareholder must take into account separately the shareholder's pro rata share of any item of income (including tax-exempt income), loss, deduction, or credit of the S corporation that if separately taken into account by any shareholder could affect the shareholder's tax liability for that taxable year differently than if the shareholder did not take the item into account separately. The separately stated items of the S corporation include, but are not limited to, the following items—

(i) The corporation's combined net amount of gains and losses from sales or exchanges of capital assets grouped by applicable holding periods, by applicable rate of tax under section 1(h), and by any other classification that may be relevant in determining the shareholder's tax liability;

(ii) The corporation's combined net amount of gains and losses from sales or exchanges of property described in section 1231 (relating to property used in the trade or business and involuntary conversions), grouped by applicable holding periods, by applicable rate of tax under section 1(h), and by any other classification that may be relevant in determining the shareholder's tax liability;

(iii) Charitable contributions, grouped by the percentage limitations of section 170(b), paid by the corporation within the taxable year of the corporation;

(iv) The taxes described in section 901 that have been paid (or accrued) by the corporation to foreign countries or to possessions of the United States;

(v) Each of the corporation's separate items involved in the determination of credits against tax allowable under part IV of subchapter A (section 21 and following) of the Internal Revenue Code, except for any credit allowed under section 34 (relating to certain uses of gasoline and special fuels);

(vi) Each of the corporation's separate items of gains and losses from wagering transactions (section 165(d)); soil and water conservation expenditures (section 175); deduction under an election to expense certain depreciable

business expenses (section 179); medical, dental, etc., expenses (section 213); the additional itemized deductions for individuals provided in part VII of subchapter B (section 212 and following) of the Internal Revenue Code; and any other itemized deductions for which the limitations on itemized deductions under sections 67 or 68 applies;

(vii) Any of the corporation's items of portfolio income or loss, and expenses related thereto, as defined in the regulations under section 469;

(viii) The corporation's tax-exempt income. For purposes of subchapter S, tax-exempt income is income that is permanently excludible from gross income in all circumstances in which the applicable provision of the Internal Revenue Code applies. For example, income that is excludible from gross income under section 101 (certain death benefits) or section 103 (interest on state and local bonds) is tax-exempt income, while income that is excludible from gross income under section 108 (income from discharge of indebtedness) or section 109 (improvements by lessee on lessor's property) is not tax-exempt income;

(ix) The corporation's adjustments described in sections 56 and 58, and items of tax preference described in section 57; and

(x) Any item identified in guidance (including forms and instructions) issued by the Commissioner as an item required to be separately stated under this paragraph (a)(2).

(3) *Nonseparately computed income or loss.* Each shareholder must take into account separately the shareholder's pro rata share of the nonseparately computed income or loss of the S corporation. For this purpose, nonseparately computed income or loss means the corporation's gross income less the deductions allowed to the corporation under chapter 1 of the Internal Revenue Code, determined by excluding any item requiring separate computation under paragraph (a)(2) of this section.

(4) *Separate activities requirement.* An S corporation must report, and each shareholder must take into account in the shareholder's return, the shareholder's pro rata share of an S corporation's items of income, loss, deduction, or credit described in paragraphs (a)(2) and (3) of this section for each of the corporation's activities as defined in section 469 and the regulations thereunder.

(5) *Aggregation of deductions or exclusions for purposes of limitations*—(i) *In general.* A shareholder aggregates the shareholder's separate deductions or exclusions with the shareholder's pro rata share of the S corporation's separately stated deductions or exclusions in determining the amount of any deduction or exclusion allowable to the shareholder under subtitle A of the Internal Revenue Code as to which a limitation is imposed.

(ii) *Example.* The provisions of paragraph (a)(5)(i) of this section are illustrated by the following example:

Example. In 1999, Corporation M, a calendar year S corporation, purchases and places in service section 179 property costing $10,000. Corporation M elects to expense the entire cost of the property. Shareholder A owns 50 percent of the stock of Corporation M. Shareholder A's pro rata share of this item after Corporation M applies the section 179(b) limitations is $5,000. Because the aggregate amount of Shareholder A's pro rata share and separately acquired section 179 expense may not exceed $19,000 (the aggregate maximum cost that may be taken into account under section 179(a) for the applicable taxable year), Shareholder A may elect to expense up to $14,000 of separately acquired section 179 property that is purchased and placed in service in 1999, subject to the limitations of section 179(b).

(b) *Character of items constituting pro rata share*—(1) *In general.* Except as provided in paragraph (b)(2) or (3) of this section, the character of any item of income, loss, deduction, or credit described in section 1366(a)(1)(A) or (B) and paragraph (a) of this section is determined for the S corporation and retains that character in the hands of the shareholder. For example, if an S corporation has capital gain on the sale or exchange of a capital asset, a shareholder's pro rata share of that gain will also be characterized as a capital gain regardless of whether the shareholder is otherwise a dealer in that type of property. Similarly, if an S corporation engages in an activity that is not for profit (as defined in section 183), a shareholder's pro rata share of the S

corporation's deductions will be characterized as not for profit. Also, if an S corporation makes a charitable contribution to an organization qualifying under section 170(b)(1)(A), a shareholder's pro rata share of the S corporation's charitable contribution will be characterized as made to an organization qualifying under section 170(b)(1)(A).

(2) *Exception for contribution of noncapital gain property.* If an S corporation is formed or availed of by any shareholder or group of shareholders for a principal purpose of selling or exchanging contributed property that in the hands of the shareholder or shareholders would not have produced capital gain if sold or exchanged by the shareholder or shareholders, then the gain on the sale or exchange of the property recognized by the corporation is not treated as a capital gain.

(3) *Exception for contribution of capital loss property.* If an S corporation is formed or availed of by any shareholder or group of shareholders for a principal purpose of selling or exchanging contributed property that in the hands of the shareholder or shareholders would have produced capital loss if sold or exchanged by the shareholder or shareholders, then the loss on the sale or exchange of the property recognized by the corporation is treated as a capital loss to the extent that, immediately before the contribution, the adjusted basis of the property in the hands of the shareholder or shareholders exceeded the fair market value of the property.

(c) *Gross income of a shareholder*—(1) *In general.* Where it is necessary to determine the amount or character of the gross income of a shareholder, the shareholder's gross income includes the shareholder's pro rata share of the gross income of the S corporation. The shareholder's pro rata share of the gross income of the S corporation is the amount of gross income of the corporation used in deriving the shareholder's pro rata share of S corporation taxable income or loss (including items described in section 1366(a)(1)(A) or (B) and paragraph (a) of this section). For example, a shareholder is required to include the shareholder's pro rata share of S corporation gross income in computing the shareholder's gross income for the purposes of determining the necessity of filing a return (section 6012(a)) and the shareholder's gross income derived from farming (sections 175 and 6654(i)).

(2) *Gross income for substantial omission of items*—(i) *In general.* For purposes of determining the applicability of the 6-year period of limitation on assessment and collection provided in section 6501(e) (relating to omission of more than 25 percent of gross income), a shareholder's gross income includes the shareholder's pro rata share of S corporation gross income (as described in section 6501(e)(1)(A)(i)). In this respect, the amount of S corporation gross income used in deriving the shareholder's pro rata share of any item of S corporation income, loss, deduction, or credit (as included or disclosed in the shareholder's return) is considered as an amount of gross income stated in the shareholder's return for purposes of section 6501(e).

(ii) *Example.* The following example illustrates the provisions of paragraph (c)(2)(i) of this section:

Example. Shareholder A, an individual, owns 25 percent of the stock of Corporation N, an S corporation that has $10,000 gross income and $2,000 taxable income. A reports only $300 as A's pro rata share of N's taxable income. A should have reported $500 as A's pro rata share of taxable income, derived from A's pro rata share, $2,500, of N's gross income. Because A's return included only $300 without a disclosure meeting the requirements of section 6501(e)(1)(A)(ii) describing the difference of $200, A is regarded as having reported on the return only $1,500 ($300/$500 of $2,500) as gross income from N.

(d) *Shareholders holding stock subject to community property laws.* If a shareholder holds S corporation stock that is community property, then the shareholder's pro rata share of any item or items listed in paragraphs (a)(2), (3), and (4) of this section with respect to that stock is reported by the husband and wife in accordance with community property rules.

(e) *Net operating loss deduction of shareholder of S corporation.* For purposes of determining a net operating loss deduction under section 172, a shareholder of an S corporation must take into account the shareholder's pro

rata share of items of income, loss, deduction, or credit of the corporation. See section 1366(b) and paragraph (b) of this section for rules on determining the character of the items. In determining under section 172(d)(4) the nonbusiness deductions allowable to a shareholder of an S corporation (arising from both corporation sources and any other sources), the shareholder separately takes into account the shareholder's pro rata share of the deductions of the corporation that are not attributable to a trade or business and combines this amount with the shareholder's nonbusiness deductions from any other sources. The shareholder also separately takes into account the shareholder's pro rata share of the gross income of the corporation not derived from a trade or business and combines this amount with the shareholder's nonbusiness income from all other sources. See section 172 and the regulations thereunder.

(f) *Cross-reference*. For rules relating to the consistent tax treatment of subchapter S items, see section 6037(c).

[T.D. 8852, 64 FR 71645, Dec. 22, 1999]

§ 1.1366–2 Limitations on deduction of passthrough items of an S corporation to its shareholders.

(a) *In general*—(1) *Limitation on losses and deductions*. The aggregate amount of losses and deductions taken into account by a shareholder under § 1.1366–1(a) (2), (3), and (4) for any taxable year of an S corporation cannot exceed the sum of—

(i) The adjusted basis of the shareholder's stock in the corporation (as determined under paragraph (a)(4)(i) of this section); and

(ii) The adjusted basis of any indebtedness of the corporation to the shareholder (as determined under paragraphs (a)(2) and (a)(4)(ii) of this section).

(2) *Basis of indebtedness*—(i) *In general*. The term *basis of any indebtedness of the S corporation to the shareholder* means the shareholder's adjusted basis (as defined in § 1.1011–1 and as specifically provided in section 1367(b)(2)) in any bona fide indebtedness of the S corporation that runs directly to the shareholder. Whether indebtedness is bona fide indebtedness to a shareholder is determined under general Federal tax principles and depends upon all of the facts and circumstances.

(ii) *Special rule for guarantees*. A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. When a shareholder makes a payment on bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, then the shareholder may increase the shareholder's basis of indebtedness to the extent of that payment.

(iii) *Examples*. The following examples illustrate the provisions of paragraph (a)(2)(i) and (ii) of this section:

Example 1. Shareholder loan transaction. A is the sole shareholder of S, an S corporation. S received a loan from A. Whether the loan from A to S constitutes bona fide indebtedness from S to A is determined under general Federal tax principles and depends upon all of the facts and circumstances. See paragraph (a)(2)(i) of this section. If the loan constitutes bona fide indebtedness from S to A, A's loan to S increases A's basis of indebtedness under paragraph (a)(2)(i) of this section. The result is the same if A made the loan to S through an entity that is disregarded as an entity separate from A under § 301.7701–3 of this chapter.

Example 2. Back-to-back loan transaction. A is the sole shareholder of two S corporations, S1 and S2. S1 loaned $200,000 to A. A then loaned $200,000 to S2. Whether the loan from A to S2 constitutes bona fide indebtedness from S2 to A is determined under general Federal tax principles and depends upon all of the facts and circumstances. See paragraph (a)(2)(i) of this section. If A's loan to S2 constitutes bona fide indebtedness from S2 to A, A's back-to-back loan increases A's basis of indebtedness in S2 under paragraph (a)(2)(i) of this section.

Example 3. Loan restructuring through distributions. A is the sole shareholder of two S corporations, S1 and S2. In May 2014, S1 made a loan to S2. In December 2014, S1 assigned its creditor position in the note to A by making a distribution to A of the note. Under local law, after S1 distributed the note to A, S2 was relieved of its liability to S1 and was directly liable to A. Whether S2 is indebted to A rather than S1 is determined under general Federal tax principles and depends upon all of the facts and circumstances. See paragraph (a)(2)(i) of this section. If the note constitutes bona fide indebtedness from S2 to A, the note increases

A's basis of indebtedness in S2 under paragraph (a)(2)(i) of this section.

Example 4. Guarantee. A is a shareholder of S, an S corporation. In 2014, S received a loan from Bank. Bank required A's guarantee as a condition of making the loan to S. Beginning in 2015, S could no longer make payments on the loan and A made payments directly to Bank from A's personal funds until the loan obligation was satisfied. For each payment A made on the note, A obtains basis of indebtedness under paragraph (a)(2)(ii) of this section. Thus, A's basis of indebtedness is increased during 2015 under paragraph (a)(2)(ii) of this section to the extent of A's payments to Bank pursuant to the guarantee agreement.

(3) *Carryover of disallowance.* A shareholder's aggregate amount of losses and deductions for a taxable year in excess of the sum of the adjusted basis of the shareholder's stock in an S corporation and of any indebtedness of the S corporation to the shareholder is not allowed for the taxable year. However, any disallowed loss or deduction retains its character and is treated as incurred by the corporation in the corporation's first succeeding taxable year, and subsequent taxable years, with respect to the shareholder. For rules on determining the adjusted bases of stock of an S corporation and indebtedness of the corporation to the shareholder, see paragraphs (a)(4) (i) and (ii) of this section.

(4) *Basis limitation amount*—(i) *Stock portion.* A shareholder generally determines the adjusted basis of stock for purposes of paragraphs (a)(1)(i) and (3) of this section (limiting losses and deductions) by taking into account only increases in basis under section 1367(a)(1) for the taxable year and decreases in basis under section 1367(a)(2) (A), (D) and (E) (relating to distributions, noncapital, nondeductible expenses, and certain oil and gas depletion deductions) for the taxable year. In so determining this loss limitation amount, the shareholder disregards decreases in basis under section 1367(a)(2) (B) and (C) (for losses and deductions, including losses and deductions previously disallowed) for the taxable year. However, if the shareholder has in effect for the taxable year an election under § 1.1367–1(g) to decrease basis by items of loss and deduction prior to decreasing basis by noncapital, nondeductible expenses and certain oil and gas depletion deductions, the shareholder also disregards decreases in basis under section 1367(a)(2) (D) and (E). This basis limitation amount for stock is determined at the time prescribed under § 1.1367–1(d)(1) for adjustments to the basis of stock.

(ii) *Indebtedness portion.* A shareholder determines the shareholder's adjusted basis in indebtedness of the corporation for purposes of paragraphs (a)(1)(ii) and (3) of this section (limiting losses and deductions) without regard to any adjustment under section 1367(b)(2)(A) for the taxable year. This basis limitation amount for indebtedness is determined at the time prescribed under § 1.1367–2(d)(1) for adjustments to the basis of indebtedness.

(5) *Limitation on losses and deductions allocated to each item.* If a shareholder's pro rata share of the aggregate amount of losses and deductions specified in § 1.1366–1(a)(2), (3), and (4) exceeds the sum of the adjusted basis of the shareholder's stock in the corporation (determined in accordance with paragraph (a)(4)(i) of this section) and the adjusted basis of any indebtedness of the corporation to the shareholder (determined in accordance with paragraph (a)(4)(ii) of this section), then the limitation on losses and deductions under section 1366(d)(1) must be allocated among the shareholder's pro rata share of each loss or deduction. The amount of the limitation allocated to any loss or deduction is an amount that bears the same ratio to the amount of the limitation as the loss or deduction bears to the total of the losses and deductions. For this purpose, the total of losses and deductions for the taxable year is the sum of the shareholder's pro rata share of losses and deductions for the taxable year, and the losses and deductions disallowed and carried forward from prior years pursuant to section 1366(d)(2).

(6) *Nontransferability of losses and deductions*—(i) *In general.* Except as provided in paragraph (a)(6)(ii) of this section, any loss or deduction disallowed under paragraph (a)(1) of this section is personal to the shareholder and cannot in any manner be transferred to another person. If a shareholder transfers some but not all of the shareholder's stock in the corporation, the amount

of any disallowed loss or deduction under this section is not reduced and the transferee does not acquire any portion of the disallowed loss or deduction. If a shareholder transfers all of the shareholder's stock in the corporation, any disallowed loss or deduction is permanently disallowed.

(ii) *Exceptions for transfers of stock under section 1041(a).* If a shareholder transfers stock of an S corporation after December 31, 2004, in a transfer described in section 1041(a), any loss or deduction with respect to the transferred stock that is disallowed to the transferring shareholder under paragraph (a)(1) of this section shall be treated as incurred by the corporation in the following taxable year with respect to the transferee spouse or former spouse. The amount of any loss or deduction with respect to the stock transferred shall be determined by prorating any losses or deductions disallowed under paragraph (a)(1) of this section for the year of the transfer between the transferor and the spouse or former spouse based on the stock ownership at the beginning of the following taxable year. If a transferor claims a deduction for losses in the taxable year of transfer, then under paragraph (a)(5) of this section, if the transferor's pro rata share of the losses and deductions in the year of transfer exceeds the transferor's basis in stock and the indebtedness of the corporation to the transferor, then the limitation must be allocated among the transferor spouse's pro rata share of each loss or deduction, including disallowed losses and deductions carried over from the prior year.

(iii) *Examples.* The following examples illustrates the provisions of paragraph (a)(6)(ii) of this section:

Example 1. A owns all 100 shares in *X*, a calendar year S corporation. For *X*'s taxable year ending December 31, 2006, *A* has zero basis in the shares and *X* does not have any indebtedness to *A*. For the 2006 taxable year, *X* had $100 in losses that *A* cannot use because of the basis limitation in section 1366(d)(1) and that are treated as incurred by the corporation with respect to *A* in the following taxable year. Halfway through the 2007 taxable year, *A* transfers 50 shares to *B*, *A*'s former spouse in a transfer to which section 1041(a) applies. In the 2007 taxable year, *X* has $80 in losses. On *A*'s 2007 individual income tax return, *A* may use the entire $100 carryover loss from 2006, as well as *A*'s share of the $80 2007 loss determined under section 1377(a) ($60), assuming A acquires sufficient basis in the *X* stock. On *B*'s 2007 individual income tax return, *B* may use *B*'s share of the $80 2007 loss determined under section 1377(a) ($20), assuming *B* has sufficient basis in the *X* stock. If any disallowed 2006 loss is disallowed to *A* under section 1366(d)(1) in 2007, that loss is prorated between *A* and *B* based on their stock ownership at the beginning of 2008. On *B*'s 2008 individual income tax return, *B* may use that loss, assuming *B* acquires sufficient basis in the *X* stock. If neither *A* nor *B* acquires any basis during the 2007 taxable year, then as of the beginning of 2008, the corporation will be treated as incurring $50 of loss with respect to *A* and $50 of loss with respect to *B* for the $100 of disallowed 2006 loss, and the corporation will be treated as incurring $60 of loss with respect to *A* and $20 with respect to *B* for the $80 of disallowed 2007 loss.

Example 2. Assume the same facts as *Example 1*, except that during the 2007 taxable year, *A* acquires $10 of basis in *A*'s shares in *X*. For the 2007 taxable year, *A* may claim a $10 loss deduction, which represents $6.25 of the disallowed 2006 loss of $100 and $3.75 of *A*'s 2007 loss of $60. The disallowed 2006 loss is reduced to $93.75. As of the beginning of 2008, the corporation will be treated as incurring half of the remaining $93.75 of loss with respect to *A* and half of that loss with respect to *B* for the remaining $93.75 of disallowed 2006 loss, and if *B* does not acquire any basis during 2007, the corporation will be treated as incurring $56.25 of loss with respect to *A* and $20 with respect to *B* for the remaining disallowed 2007 loss.

(7) *Basis of stock acquired by gift.* For purposes of section 1366(d)(1)(A) and paragraphs (a)(1)(i) and (3) of this section, the basis of stock in a corporation acquired by gift is the basis of the stock that is used for purposes of determining loss under section 1015(a).

(b) *Special rules for carryover of disallowed losses and deductions to post-termination transition period described in section 1377(b)*—(1) *In general.* If, for the last taxable year of a corporation for which it was an S corporation, a loss or deduction was disallowed to a shareholder by reason of the limitation in paragraph (a) of this section, the loss or deduction is treated under section 1366(d)(3) as incurred by that shareholder on the last day of any post-termination transition period (within the meaning of section 1377(b)).

(2) *Limitation on losses and deductions.* The aggregate amount of losses and deductions taken into account by a shareholder under paragraph (b)(1) of this section cannot exceed the adjusted basis of the shareholder's stock in the corporation determined at the close of the last day of the post-termination transition period. For this purpose, the adjusted basis of a shareholder's stock in the corporation is determined at the close of the last day of the post-termination transition period without regard to any reduction required under paragraph (b)(4) of this section. If a shareholder disposes of a share of stock prior to the close of the last day of the post-termination transition period, the adjusted basis of that share is its basis as of the close of the day of disposition. Any losses and deductions in excess of a shareholder's adjusted stock basis are permanently disallowed. For purposes of section 1366(d)(3)(B) and this paragraph (b)(2), the basis of stock in a corporation acquired by gift is the basis of the stock that is used for purposes of determining loss under section 1015(a).

(3) *Limitation on losses and deductions allocated to each item.* If the aggregate amount of losses and deductions treated as incurred by the shareholder under paragraph (b)(1) of this section exceeds the adjusted basis of the shareholder's stock determined under paragraph (b)(2) of this section, the limitation on losses and deductions under section 1366(d)(3)(B) must be allocated among each loss or deduction. The amount of the limitation allocated to each loss or deduction is an amount that bears the same ratio to the amount of the limitation as the amount of each loss or deduction bears to the total of all the losses and deductions.

(4) *Adjustment to the basis of stock.* The shareholder's basis in the stock of the corporation is reduced by the amount allowed as a deduction by reason of this paragraph (b). For rules regarding adjustments to the basis of a shareholder's stock in an S corporation, see § 1.1367–1.

(c) *Carryover of disallowed losses and deductions in the case of liquidations, reorganizations, and divisions*—(1) *Liquidations and reorganizations.* If a corporation acquires the assets of an S corporation in a transaction to which section 381(a) applies, any loss or deduction disallowed under paragraph (a) of this section with respect to a shareholder of the distributor or transferor S corporation is available to that shareholder as a shareholder of the acquiring corporation. Thus, where the acquiring corporation is an S corporation, a loss or deduction of a shareholder of the distributor or transferor S corporation disallowed prior to or during the taxable year of the transaction is treated as incurred by the acquiring S corporation with respect to that shareholder if the shareholder is a shareholder of the acquiring S corporation after the transaction. Where the acquiring corporation is a C corporation, a post-termination transition period arises the day after the last day that an S corporation was in existence and the rules provided in paragraph (b) of this section apply with respect to any shareholder of the acquired S corporation that is also a shareholder of the acquiring C corporation after the transaction. See the special rules under section 1377 for the availability of the post-termination transition period if the acquiring corporation is a C corporation.

(2) *Corporate separations to which section 368(a)(1)(D) applies.* If an S corporation transfers a portion of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, any loss or deduction disallowed under paragraph (a) of this section with respect to a shareholder of the distributing S corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation with respect to the shareholder. Such allocation shall be made according to any reasonable method, including a method based on the relative fair market value of the shareholder's stock in the distributing and controlled corporations immediately after the distribution, a method based on the relative adjusted basis of the assets in the distributing and controlled

corporations immediately after the distribution, or, in the case of losses and deductions clearly attributable to either the distributing or controlled corporation, any method that allocates such losses and deductions accordingly.

[T.D. 8852, 64 FR 71646, Dec. 22, 1999, as amended by T.D. 9422, 73 FR 47531, Aug. 14, 2008; T.D. 9682, 79 FR 42678, July 23, 2014]

§ 1.1366–3 Treatment of family groups.

(a) *In general.* Under section 1366(e), if an individual, who is a member of the family of one or more shareholders of an S corporation, renders services for, or furnishes capital to, the corporation without receiving reasonable compensation, the Commissioner shall prescribe adjustments to those items taken into account by the individual and the shareholders as may be necessary to reflect the value of the services rendered or capital furnished. For these purposes, in determining the reasonable value for services rendered, or capital furnished, to the corporation, consideration will be given to all the facts and circumstances, including the amount that ordinarily would be paid in order to obtain comparable services or capital from a person (other than a member of the family) who is not a shareholder in the corporation. In addition, for purposes of section 1366(e), if a member of the family of one or more shareholders of the S corporation holds an interest in a passthrough entity (e.g., a partnership, S corporation, trust, or estate), that performs services for, or furnishes capital to, the S corporation without receiving reasonable compensation, the Commissioner shall prescribe adjustments to the passthrough entity and the corporation as may be necessary to reflect the value of the services rendered or capital furnished. For purposes of section 1366(e), the term *family* of any shareholder includes only the shareholder's spouse, ancestors, lineal descendants, and any trust for the primary benefit of any of these persons.

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

Example 1. The stock of an S corporation is owned 50 percent by F and 50 percent by T, the minor son of F. For the taxable year, the corporation has items of taxable income equal to $70,000. Compensation of $10,000 is paid by the corporation to F for services rendered during the taxable year, and no compensation is paid to T, who rendered no services. Based on all the relevant facts and circumstances, reasonable compensation for the services rendered by F would be $30,000. In the discretion of the Internal Revenue Service, up to an additional $20,000 of the $70,000 of the corporation's taxable income, for tax purposes, may be allocated to F as compensation for services rendered. If the Internal Revenue Service allocates $20,000 of the corporation's taxable income to F as compensation for services, taxable income of the corporation would be reduced by $20,000 to $50,000, of which F and T each would be allocated $25,000. F would have $30,000 of total compensation paid by the corporation for services rendered.

Example 2. The stock of an S corporation is owned by A and B. For the taxable year, the corporation has paid compensation to a partnership that rendered services to the corporation during the taxable year. The spouse of A is a partner in that partnership. Consequently, if based on all the relevant facts and circumstances the partnership did not receive reasonable compensation for the services rendered to the corporation, the Internal Revenue Service, in its discretion, may make adjustments to those items taken into account by the partnership and the corporation as may be necessary to reflect the value of the services rendered.

[T.D. 8852, 64 FR 71648, Dec. 22, 1999]

§ 1.1366–4 Special rules limiting the passthrough of certain items of an S corporation to its shareholders.

(a) *Passthrough inapplicable to section 34 credit.* Section 1.1366–1(a) does not apply to any credit allowable under section 34 (relating to certain uses of gasoline and special fuels).

(b) *Reduction in passthrough for tax imposed on built-in gains.* For purposes of § 1.1366–1(a), if for any taxable year of the S corporation a tax is imposed on the corporation under section 1374, the amount of the tax imposed is treated as a loss sustained by the S corporation during the taxable year. The character of the deemed loss is determined by allocating the loss proportionately among the net recognized built-in gains giving rise to the tax and attributing the character of each net recognized built-in gain to the allocable portion of the loss.

(c) *Reduction in passthrough for tax imposed on excess net passive income.* For

purposes of § 1.1366–1(a), if for any taxable year of the S corporation a tax is imposed on the corporation under section 1375, each item of passive investment income shall be reduced by an amount that bears the same ratio to the amount of the tax as the net amount of the item bears to the total net passive investment income for that taxable year.

[T.D. 8852, 64 FR 71648, Dec. 22, 1999; 65 FR 12471, Mar. 9, 2000]

§ 1.1366–5 Effective/applicability date.

(a) Sections 1.1366–1, 1.1366–2(a)(1), and 1.1366–2(b) through 1.1366–4 apply to taxable years of an S corporation beginning on or after August 18, 1998.

(b) Section 1.1366–2(a)(2) applies to indebtedness between an S corporation and its shareholder resulting from any transaction occurring on or after July 23, 2014. In addition, S corporations and their shareholders may rely on § 1.1366–2(a)(2) with respect to indebtedness between an S corporation and its shareholder that resulted from any transaction that occurred in a year for which the period of limitations on the assessment of tax has not expired before July 23, 2014.

(c) Sections 1.1366–2(a)(3) through (7), and this section apply on and after July 23, 2014. For rules that apply before that date, see 26 CFR part 1 (revised as of April 1, 2014).

[T.D. 9682, 79 FR 42678, July 23, 2014]

§ 1.1367–0 Table of contents.

The following table of contents is provided to facilitate the use of §§ 1.1367–1 through 1.1367–3.

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§ 1.1367–3 Effective date and transition rule.

[T.D. 8508, 59 FR 15, Jan. 3, 1994, as amended by T.D. 8852, 64 FR 71648, Dec. 22, 1999]

§ 1.1367–1 Adjustments to basis of shareholder's stock in an S corporation.

(a) *In general*—(1) *Adjustments under section 1367.* This section provides rules relating to adjustments required by section 1367 to the basis of a shareholder's stock in an S corporation. Paragraph (b) of this section provides rules concerning increases in the basis of a shareholder's stock, and paragraph (c) of this section provides rules concerning decreases in the basis of a shareholder's stock.

(2) *Applicability of other Internal Revenue Code provisions.* In addition to the adjustments required by section 1367 and this section, the basis of stock is determined or adjusted under other applicable provisions of the Internal Revenue Code.

(b) *Increase in basis of stock*—(1) *In general.* Except as provided in § 1.1367–2(c) (relating to restoration of basis of indebtedness to the shareholder), the basis of a shareholder's stock in an S corporation is increased by the sum of

the items described in section 1367(a)(1). The increase in basis described in section 1367(a)(1)(C) for the excess of the deduction for depletion over the basis of the property subject to depletion does not include the depletion deduction attributable to oil or gas property. See section 613(A)(c)(11).

(2) *Amount of increase in basis of individual shares.* The basis of a shareholder's share of stock is increased by an amount equal to the shareholder's pro rata portion of the items described in section 1367(a)(1) that is attributable to that share, determined on a per share, per day basis in accordance with section 1377(a).

(c) *Decrease in basis of stock*—(1) *In general.* The basis of a shareholder's stock in an S corporation is decreased (but not below zero) by the sum of the items described in section 1367(a)(2).

(2) *Noncapital, nondeductible expenses.* For purposes of section 1367(a)(2)(D), expenses of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account (*noncapital, nondeductible expenses*) are only those items for which no loss or deduction is allowable and do not include items the deduction for which is deferred to a later taxable year. Examples of noncapital, nondeductible expenses include (but are not limited to) the following: Illegal bribes, kickbacks, and other payments not deductible under section 162(c); fines and penalties not deductible under section 162(f); expenses and interest relating to tax-exempt income under section 265; losses for which the deduction is disallowed under section 267(a)(1); the portion of meals and entertainment expenses disallowed under section 274; and the two-thirds portion of treble damages paid for violating antitrust laws not deductible under section 162. For basis adjustments necessary to coordinate sections 1367 and 362(e)(2), see § 1.362–4(e)(2).

(3) *Amount of decrease in basis of individual shares.* The basis of a shareholder's share of stock is decreased by an amount equal to the shareholder's pro rata portion of the passthrough items and distributions described in section 1367(a)(2) attributable to that share, determined on a per share, per day basis in accordance with section 1377(a). If the amount attributable to a share exceeds its basis, the excess is applied to reduce (but not below zero) the remaining bases of all other shares of stock in the corporation owned by the shareholder in proportion to the remaining basis of each of those shares.

(d) *Time at which adjustments to basis of stock are effective*—(1) *In general.* The adjustments described in section 1367(a) to the basis of a shareholder's stock are determined as of the close of the corporation's taxable year, and the adjustments generally are effective as of that date. However, if a shareholder disposes of stock during the corporation's taxable year, the adjustments with respect to that stock are effective immediately prior to the disposition.

(2) *Adjustment for nontaxable item.* An adjustment for a nontaxable item is determined for the taxable year in which the item would have been includible or deductible under the corporation's method of accounting for Federal income tax purposes if the item had been subject to Federal income taxation.

(3) *Effect of election under section 1377(a)(2) or § 1.1368–1(g)(2).* If an election under section 1377(a)(2) (to terminate the year in the case of the termination of a shareholder's interest) or under § 1.1368–1(g)(2) (to terminate the year in the case of a qualifying disposition) is made with respect to the taxable year of a corporation, this paragraph (d) applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which either the shareholder's interest is terminated or a qualifying disposition occurs, whichever the case may be.

(e) *Ordering rules for taxable years beginning before January 1, 1997.* For any taxable year of a corporation beginning before January 1, 1997, except as provided in paragraph (g) of this section, the adjustments required by section 1367(a) are made in the following order—

(1) Any increase in basis attributable to the income items described in section 1367(a)(1) (A) and (B) and the excess of the deductions for depletion described in section 1367(a)(1)(C);

(2) Any decrease in basis attributable to noncapital, nondeductible expenses described in section 1367(a)(2)(D) and

the oil and gas depletion deduction described in section 1367(a)(2)(E);

(3) Any decrease in basis attributable to items of loss or deduction described in section 1367(a)(2) (B) and (C); and

(4) Any decrease in basis attributable to a distribution by the corporation described in section 1367(a)(2)(A).

(f) *Ordering rules for taxable years beginning on or after August 18, 1998.* For any taxable year of a corporation beginning on or after August 18, 1998, except as provided in paragraph (g) of this section, the adjustments required by section 1367(a) are made in the following order—

(1) Any increase in basis attributable to the income items described in section 1367(a)(1)(A) and (B), and the excess of the deductions for depletion described in section 1367(a)(1)(C);

(2) Any decrease in basis attributable to a distribution by the corporation described in section 1367(a)(2)(A);

(3) Any decrease in basis attributable to noncapital, nondeductible expenses described in section 1367(a)(2)(D), and the oil and gas depletion deduction described in section 1367(a)(2)(E); and

(4) Any decrease in basis attributable to items of loss or deduction described in section 1367(a)(2)(B) and (C).

(g) *Elective ordering rule.* A shareholder may elect to decrease basis under paragraph (e)(3) or (f)(4) of this section, whichever applies, prior to decreasing basis under paragraph (e)(2) or (f)(3) of this section, whichever applies. If a shareholder makes this election, any amount described in paragraph (e)(2) or (f)(3) of this section, whichever applies, that is in excess of the shareholder's basis in stock and indebtedness is treated, solely for purposes of this section, as an amount described in paragraph (e)(2) or (f)(3) of this section, whichever applies, in the succeeding taxable year. A shareholder makes the election under this paragraph by attaching a statement to the shareholder's timely filed original or amended return that states that the shareholder agrees to the carryover rule of the preceding sentence. Once a shareholder makes an election under this paragraph with respect to an S corporation, the shareholder must continue to use the rules of this paragraph for that S corporation in future taxable years unless the shareholder receives the permission of the Commissioner.

(h) *Examples.* The following examples illustrate the principles of § 1.1367–1. In each example, the corporation is a calendar year S corporation:

Example 1. Adjustments to basis of stock for taxable years beginning before January 1, 1997. (i) On December 31, 1994, A owns a block of 50 shares of stock with an adjusted basis per share of $6 in Corporation S. On December 31, 1994, A purchases for $400 an additional block of 50 shares of stock with an adjusted basis of $8 per share. Thus, A holds 100 shares of stock for each day of the 1995 taxable year. For S's 1995 taxable year, A's pro rata share of the amount of the items described in section 1367(a)(1)(A) (relating to increases in basis of stock) is $300, and A's pro rata share of the amount of the items described in section 1367(a)(2) (B) and (D) (relating to decreases in basis of stock) is $500. S makes a distribution to A in the amount of $100 during 1995.

(ii) Pursuant to the ordering rules of paragraph (e) of this section, A increases the basis of each share of stock by $3 ($300/100 shares) and decreases the basis of each share of stock by $5 ($500/100 shares). Then A reduces the basis of each share by $1 ($100/100 shares) for the distribution. Thus, on January 1, 1996, A has a basis of $3 per share in his original block of 50 shares ($6 + $3 − $5 − $1) and a basis of $5 per share in the second block of 50 shares ($8 + $3 − $5 − $1).

Example 2. Adjustments to basis of stock for taxable years beginning on or after August 18, 1998. (i) On December 31, 2001, A owns a block of 50 shares of stock with an adjusted basis per share of $6 in Corporation S. On December 31, 2001, A purchases for $400 an additional block of 50 shares of stock with an adjusted basis of $8 per share. Thus, A holds 100 shares of stock for each day of the 2002 taxable year. For S's 2002 taxable year, A's pro rata share of the amount of items described in section 1367(a)(1)(A) (relating to increases in basis of stock) is $300, A's pro rata share of the amount of the items described in section 1367(a)(2)(B) (relating to decreases in basis of stock attributable to items of loss and deduction) is $300, and A's pro rata share of the amount of the items described in section 1367(a)(2)(D) (relating to decreases in basis of stock attributable to noncapital, nondeductible expenses) is $200. S makes a distribution to A in the amount of $100 during 2002.

(ii) Pursuant to the ordering rules of paragraph (f) of this section, A first increases the basis of each share of stock by $3 ($300/100 shares) and then decreases the basis of each share by $1 ($100/100 shares) for the distribution. A next decreases the basis of each share by $2 ($200/100 shares) for the noncapital,

nondeductible expenses and then decreases the basis of each share by $3 ($300/100 shares) for the items of loss. Thus, on January 1, 2003, A has a basis of $3 per share in the original block of 50 shares ($6 + $3 − $1 − $2 − $3) and a basis of $5 per share in the second block of 100 shares ($8 + $3 − $1 − $2 − $3).

Example 3. Adjustments attributable to basis of individual shares of stock. (i) On December 31, 1993, B owns one share of S corporation's 10 outstanding shares of stock. The basis of B's share is $30. On July 2, 1994, B purchases from another shareholder two shares for $25 each. During 1994, S corporation has no income or deductions but incurs a loss of $365. Under section 1377(a)(1)(A) and paragraph (c)(3) of this section, the amount of the loss assigned to each day of S's taxable year is $1.00 ($365/365 days). For each day, $.10 is allocated to each outstanding share ($1.00 amount of loss assigned to each day/10 shares).

(ii) B owned one share for 365 days and, therefore, reduces the basis of that share by the amount of loss attributable to it, i.e., $36.50 ($.10 × 365 days). B owned two shares for 182 days and, therefore, reduces the basis of each of those shares by the amount of the loss attributable to each, i.e., $18.20 ($.10 × 182 days).

(iii) The bases of the shares are decreased as follows:

Share	Original basis	Decrease	Adjusted basis	Excess basis reduction
No. 1	$30.00	$36.50	$0	$6.50
No. 2	25.00	18.20	6.80	0
No. 3	25.00	18.20	6.80	0
Total remaining basis			13.60	

(iv) Because the decrease in basis attributable to share No. 1 exceeds the basis of share No. 1 by $6.50 ($36.50 − $30.00), the excess is applied to reduce the bases of shares No. 2 and No. 3 in proportion to their remaining bases. Therefore, the bases of share No. 2 and share No. 3 are each decreased by an additional $3.25 ($6.50 × $6.80/$13.60). After this decrease, Share No. 1 has a basis of zero, Share No. 2 has a basis of $3.55, and Share No. 3 has a basis of $3.55.

Example 4. Effects of section 1377(a)(2) election and distribution on basis of stock for taxable years beginning before January 1, 1997. (i) On January 1, 1994, individuals B and C each own 50 of the 100 shares of issued and outstanding stock of Corporation S. B's adjusted basis in each share of stock is $120, and C's is $80. On June 30, 1994, S distributes $6,000 to B and $6,000 to C. On June 30, 1994, B sells all of her S stock for $10,000 to D. S elects under section 1377(a)(2) to treat its 1994 taxable year as consisting of two taxable years, the first of which ends at the close of June 30, the date on which B terminates her interest in S.

(ii) For the period January 1, 1994, through June 30, 1994, S has nonseparately computed income of $6,000 and a separately stated deduction item of $4,000. Therefore, on June 30, 1994, B and C, pursuant to the ordering rules of paragraph (e) of this section, increase the basis of each share by $60 ($6,000/100 shares) and decrease the basis of each share by $40 ($4,000/100 shares). Then B and C reduce the basis of each share by $120 ($12,000/100 shares) for the distribution.

(iii) The basis of B's stock is reduced from $120 to $20 per share ($120 + $60 − $40 − $120). The basis of C's stock is reduced from $80 to $0 per share ($80 + $60 − $40 − $120). See section 1368 and § 1.1368–1 (c) and (d) for rules relating to the tax treatment of the distributions.

(iv) Pursuant to paragraph (d)(3) of this section, the net reduction in the basis of B's shares of the S stock required by section 1367 and this section is effective immediately prior to B's sale of her stock. Thus, B's basis for determining gain or loss on the sale of the S stock is $20 per share, and B has a gain on the sale of $180 ($200 − $20) per share.

Example 5. Effects of section 1377(a)(2) election and distribution on basis of stock for taxable years beginning on or after August 18, 1998. (i) The facts are the same as in *Example 4*, except that all of the events occur in 2001 rather than in 1994 and except as follows: On June 30, 2001, B sells 25 shares of her stock for $5,000 to D and 25 shares back to Corporation S for $5,000. Under section 1377(a)(2)(B) and § 1.1377–1(b)(2), B, C, and D are affected shareholders because B has transferred shares to Corporations S and D. Pursuant to section 1377(a)(2)(A) and § 1.1377–1(b)(1), B, C, and D, the affected shareholders, and Corporation S agree to treat the taxable year 2001 as if it consisted of two separate taxable years for all affected shareholders for the purposes set forth in § 1.1377–1(b)(3)(i).

(ii) On June 30, 2001, B and C, pursuant to the ordering rules of paragraph (f)(1) of this section, increase the basis of each share by $60 ($6,000/100 shares) for the nonseparately computed income. Then B and C reduce the basis of each share by $120 ($12,000/100 shares) for the distribution. Finally, B and C decrease the basis of each share by $40 ($4,000/100 shares) for the separately stated deduction item.

(iii) The basis of the stock of B is reduced from $120 to $20 per share ($120 + $60 − $120 − $40). Prior to accounting for the separately stated deduction item, the basis of the stock of C is reduced from $80 to $20 ($80 + $60 − $120). Finally, because the period from January 1 through June 30, 2001 is treated under § 1.1377–1(b)(3)(i) as a separate taxable year for purposes of making adjustments to the basis of stock, under section 1366(d) and § 1.1366–2(a)(3), C may deduct only $20 per share of the remaining $40 of the separately

stated deduction item, and the basis of the stock of C is reduced from $20 per share to $0 per share. Under section 1366 and § 1.1366–2(a)(3), C's remaining separately stated deduction item of $20 per share is treated as having been incurred in the first succeeding taxable year of Corporation S, which, for this purpose, begins on July 1, 2001.

(i) [Reserved]

(j) *Adjustments for items of income in respect of a decedent*. The basis determined under section 1014 of any stock in an S corporation is reduced by the portion of the value of the stock that is attributable to items constituting income in respect of a decedent. For the determination of items realized by an S corporation constituting income in respect of a decedent, see sections 1367(b)(4)(A) and 691 and applicable regulations thereunder. For the determination of the allowance of a deduction for the amount of estate tax attributable to income in respect of a decedent, see section 691(c) and applicable regulations thereunder.

[T.D. 8508, 59 FR 15, Jan. 3, 1994, as amended by T.D. 8852, 64 FR 71648, Dec. 22, 1999; 65 FR 12471, Mar. 9, 2000; 65 FR 16319, Mar. 28, 2000; T.D. 9633, 78 FR 54168, Sept. 3, 2013; T.D. 9682, 79 FR 42678, July 23, 2014; T.D. 9759, 81 FR 17083, Mar. 28, 2016]

§ 1.1367–2 Adjustments to basis of indebtedness to shareholder.

(a) *In general*—(1) *Adjustments under section 1367*. This section provides rules relating to adjustments required by subchapter S to the basis of indebtedness (including open account debt as described in paragraph (a)(2) of this section) of an S corporation to a shareholder. The basis of indebtedness of the S corporation to a shareholder is reduced as provided in paragraph (b) of this section and restored as provided in paragraph (c) of this section in accordance with the timing rules in paragraph (d) of this section.

(2) *Open Account Debt*—(i) *General rule*. The term *open account debt* means shareholder advances not evidenced by separate written instruments and repayments on the advances, the aggregate outstanding principal of which does not exceed $25,000 of indebtedness of the S corporation to the shareholder at the close of the S corporation's taxable year. Advances and repayments on open account debt are treated as a single indebtedness.

(ii) *Exception*. If the shareholder advances not evidenced by a separate written instrument, net of repayments, exceeds an aggregate outstanding principal amount of $25,000 at the close of the S corporation's taxable year, for any subsequent taxable year the aggregate principal amount of that indebtedness is treated in the same manner as indebtedness evidenced by a separate written instrument for purposes of this section. For any subsequent taxable year, that indebtedness is not open account debt and is subject to all basis adjustment rules applicable to basis of indebtedness of an S corporation to a shareholder in this section.

(b) *Reduction in basis of indebtedness*—(1) *General rule*. If, after making the adjustments required by section 1367(a)(1) for any taxable year of the S corporation, the amounts specified in section 1367(a)(2) (B), (C), (D), and (E) (relating to losses, deductions, noncapital, nondeductible expenses, and certain oil and gas depletion deductions) exceed the basis of a shareholder's stock in the corporation, the excess is applied to reduce (but not below zero) the basis of any indebtedness of the S corporation to the shareholder held by the shareholder at the close of the corporation's taxable year. Any such indebtedness that has been satisfied by the corporation, or disposed of or forgiven by the shareholder, during the taxable year, is not held by the shareholder at the close of that year and is not subject to basis reduction.

(2) *Termination of shareholder's interest in corporation during taxable year*. If a shareholder terminates his or her interest in the corporation during the taxable year, the rules of this paragraph (b) are applied with respect to any indebtedness of the S corporation held by the shareholder immediately prior to the termination of the shareholder's interest in the corporation.

(3) *Multiple indebtedness*. If a shareholder holds more than one indebtedness at the close of the corporation's taxable year or, if applicable, immediately prior to the termination of the shareholder's interest in the corporation, the reduction in basis is applied

to each indebtedness in the same proportion that the basis of each indebtedness bears to the aggregate bases of the indebtedness to the shareholder.

(c) *Restoration of basis*—(1) *General rule*. If, for any taxable year of an S corporation beginning after December 31, 1982, there has been a reduction in the basis of an indebtedness of the S corporation to a shareholder under section 1367(b)(2)(A), any *net increase* in any subsequent taxable year of the corporation is applied to restore that reduction. For purposes of this section, *net increase* with respect to a shareholder means the amount by which the shareholder's pro rata share of the items described in section 1367(a)(1) (relating to income items and excess deduction for depletion) exceed the items described in section 1367(a)(2) (relating to losses, deductions, noncapital, nondeductible expenses, certain oil and gas depletion deductions, and certain distributions) for the taxable year. These restoration rules apply only to indebtedness held by a shareholder as of the beginning of the taxable year in which the net increase arises. The reduction in basis of indebtedness must be restored before any net increase is applied to restore the basis of a shareholder's stock in an S corporation. In no event may the shareholder's basis of indebtedness be restored above the adjusted basis of the indebtedness under section 1016(a), excluding any adjustments under section 1016(a)(17) for prior taxable years, determined as of the beginning of the taxable year in which the net increase arises.

(2) *Multiple indebtedness*. If a shareholder holds more than one indebtedness (including any open account debt and any debt treated as a single indebtedness under paragraph (a)(2)(ii) of this section) as of the beginning of an S corporation's taxable year, any net increase is applied first to restore the reduction of basis in any indebtedness repaid (in whole or in part) in that taxable year to the extent necessary to offset any gain that would otherwise be realized on the repayment. Any remaining net increase is applied to restore each outstanding indebtedness (including any open account debt and any debt treated as a single indebtedness under paragraph (a)(2)(ii) of this section) in proportion to the amount that the basis of each outstanding indebtedness has been reduced under section 1367(b)(2)(A) and paragraph (b) of this section and not restored under section 1367(b)(2)(B) and this paragraph (c).

(d) *Time at which adjustments to basis of indebtedness are effective*—

(1) *In general*. The amounts of the adjustments to basis of indebtedness (including open account debt) provided in section 1367(b)(2) and this section are determined as of the close of the S corporation's taxable year, and the adjustments are generally effective as of the close of the S corporation's taxable year. However, if the shareholder is not a shareholder in the S corporation at that time, these adjustments are effective immediately before the shareholder terminates his or her interest in the S corporation. Except as provided in paragraph (d)(2) of this section, if a debt is disposed of or repaid in whole or in part before the close of the taxable year, the basis of that indebtedness is restored under paragraph (c) of this section, effective immediately before the disposition or the first repayment on the debt during the taxable year. To the extent any indebtedness of the S corporation to the shareholder is disposed of or repaid (in whole or in part) during the taxable year and the shareholder's basis in that indebtedness has been reduced under paragraph (b) of this section and is not restored completely under paragraph (c) of this section, the disposition or repayment is a recognition event effective immediately before the indebtedness is disposed of or repaid (in whole or in part).

(2) *Open account debt*—(i) *In general*. All advances and repayments on open account debt (as described in paragraph (a)(2)(i) of this section) during the S corporation's taxable year are netted at the close of the S corporation's taxable year to determine the amount of any net advance or net repayment. The net advance or net repayment is combined with the outstanding aggregate principal balance of the existing open account debt and that amount is carried forward to the beginning of the subsequent taxable year as the outstanding aggregate principal amount of

the open account debt (unless the aggregate principal amount meets the exception defined in paragraph (a)(2)(ii) of this section at the close of the taxable year). However, if the shareholder in the S corporation is not a shareholder of the S corporation at the close of the S corporation's taxable year, such advances and repayments on open account debt are netted, and the basis of that indebtedness is restored under paragraph (c) of this section, effective immediately before the shareholder terminates his or her interest in the S corporation. If any open account debt is disposed of before or upon the close of the taxable year, the disposition is effective at the close of the S corporation's taxable year, and all advances and repayments are netted immediately prior to the disposition and the basis of that indebtedness is restored under paragraph (c) of this section, effective at the close of the S corporation's taxable year.

(ii) *Exception*. Shareholder indebtedness that is open account debt at the beginning of the taxable year but meets the exception defined in paragraph (a)(2)(ii) of this section at the close of the taxable year, adjustments to the basis of the indebtedness for that taxable year follow the provisions for open account debt. The resulting aggregate principal amount of indebtedness is treated as the principal amount of a debt evidenced by a separate written instrument for any subsequent taxable year, and is no longer subject to the open account debt provisions of this section.

(3) *Effect of election under section 1377(a)(2) or §1.1368–1(g)(2)*. If an election is made under section 1377(a)(2) (to terminate the year in the case of the termination of a shareholder's interest) or under §1.1368–1(g)(2) (to terminate the year in the case of a qualifying disposition), this paragraph (d) applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which the shareholder either terminates his or her interest in the corporation or disposes of a substantial amount of stock, whichever the case may be.

(e) *Examples*. The following examples illustrate the principles of §1.1367–2. In each example, the corporation is a calendar year S corporation. The lending transactions described in the examples do not result in foregone interest (within the meaning of section 7872(e)(2)), original issue discount (within the meaning of section 1273), or total unstated interest (within the meaning of section 483(b)).

Example 1. Reduction in basis of indebtedness. (i) A has been the sole shareholder in Corporation S since 1992. In 1993, A loans S $1,000 (Debt No. 1), which is evidenced by a ten-year promissory note in the face amount of $1,000. In 1996, A loans S $5,000 (Debt No. 2), which is evidenced by a demand promissory note. On December 31, 1996, the basis of A's stock is zero; the basis of Debt No. 1 has been reduced under paragraph (b) of this section to $0; and the basis of Debt No. 2 has been reduced to $1,000. On January 1, 1997, A loans S $4,000 (Debt No. 3), which is evidenced by a demand promissory note. For S's 1997 taxable year, the sum of the amounts specified in section 1367(a)(1) (in this case, nonseparately computed income and the excess deduction for depletion) is $6,000, and the sum of the amounts specified in section 1367(a)(2)(B), (D), and (E) (in this case, items of separately stated deductions and losses, noncapital, nondeductible expenses, and certain oil and gas depletion deductions—there is no nonseparately computed loss) is $10,000. Corporation S makes no payments to A on any of the loans during 1997.

(ii) The $4,000 excess of loss and deduction items is applied to reduce the basis of each indebtedness in proportion to the basis of that indebtedness over the aggregate bases of the indebtedness to the shareholder (determined immediately before any adjustment under section 1367(b)(2)(A) and paragraph (b) of this section is effective for the taxable year). Thus, the basis of Debt No. 2 is reduced in an amount equal to $800 ($4,000 (excess) × $1,000 (basis of Debt No. 2)/$5,000 (total basis of all debt)). Similarly, the basis in Debt No. 3 is reduced in an amount equal to $3,200 ($4,000 × $4,000/$5,000). Accordingly, on December 31, 1997, A's basis in his stock is zero and his bases in the three debts are as follows:

Debt	1/1/96 basis	12/31/96 reduction	1/1/97 basis	12/31/97 reduction	1/1/98 basis
No. 1 ..	$1,000	$1,000	$0	$0	$0
No. 2 ..	5,000	4,000	1,000	800	200
No. 3 ..	.....	.....	4,000	3,200	800

Example 2. Restoration of basis of indebtedness. (i) The facts are the same as in *Example 1*. On July 1, 1998, S completely repays Debt No. 3, and, for S's 1998 taxable year, the net increase (within the meaning of paragraph (c) of this section) with respect to A equals $4,500.

(ii) The net increase is applied first to restore the bases in the debts held on January 1, 1998, before any of the net increase is applied to increase A's basis in his shares of S stock. The net increase is applied to restore first the reduction of basis in indebtedness repaid in 1998. Any remaining net increase is applied to restore the bases of the outstanding debts in proportion to the amount that each of these outstanding debts have been reduced previously under paragraph (b) of this section and have not been restored. As of December 31, 1998, the total reduction in A's debts held on January 1, 1998 equals $9,000. Thus, the basis of Debt No. 3 is restored by $3,200 (the amount of the previous reduction) to $4,000. A's basis in Debt No. 3 is treated as restored immediately before that debt is repaid. Accordingly, A does not realize any gain on the repayment. The remaining net increase of $1,300 ($4,500 − $3,200) is applied to restore the bases of Debt No. 1 and Debt No. 2. As of December 31, 1998, the total reduction in these outstanding debts is $5,800 ($9,000 − $3,200). The basis of Debt No. 1 is restored in an amount equal to $224 ($1,300 × $1,000/$5,800). Similarly, the basis in Debt No. 2 is restored in an amount equal to $1,076 ($1,300 × $4,800/$5,800). On December 31, 1998, A's basis in his S stock is zero and his bases in the two remaining debts are as follows:

Original basis	Amount reduced	1/1/98 basis	Amount restored	12/31/98 basis
$1,000	$1,000	$0	$224	$224
5,000	4,800	200	1,076	1,276

Example 3. Full restoration of basis in indebtedness when debt is repaid in part during the taxable year. (i) C has been a shareholder in Corporation S since 1992. In 1997, C loans S $1,000. S issues its note to C in the amount of $1,000, of which $950 is payable on March 1, 1998, and $50 is payable on March 1, 1999. On December 31, 1997, C's basis in all her shares of S stock is zero and her basis in the note has been reduced under paragraph (b) of this section to $900. For 1998, the net increase (within the meaning of paragraph (c) of this section) with respect to C is $300.

(ii) Because C's basis of indebtedness was reduced in a prior taxable year under § 1.1367–2(b), the net increase for 1998 is applied to restore this reduction. The restored basis cannot exceed the adjusted basis of the debt as of the beginning of the first day of 1998, excluding prior adjustments under section 1367, or $1,000. Therefore, $100 of the $300 net increase is applied to restore the basis of the debt from $900 to $1,000 effective immediately before the repayment on March 1, 1998. The remaining net increase of $200 increases C's basis in her stock.

Example 4. Determination of net increase—distribution in excess of increase in basis. (i) D has been the sole shareholder in Corporation S since 1990. On January 1, 1996, D loans S $10,000 in return for a note from S in the amount of $10,000 of which $5,000 is payable on each of January 1, 2000, and January 1, 2001. On December 31, 1997, the basis of D's shares of S stock is zero, and his basis in the note has been reduced under paragraph (b) of this section to $8,000. During 1998, the sum of the items under section 1367(a)(1) (relating to increases in basis of stock) with respect to D equals $10,000 (in this case, nonseparately computed income), and the sum of the items under section 1367(a)(2)(B), (C), (D), and (E) (relating to decreases in basis of stock) with respect to D equals $0. During 1998, S also makes distributions to D totaling $11,000. This distribution is an item that reduces basis of stock under section 1367(a)(2)(A) and must be taken into account for purposes of determining whether there is a net increase for the taxable year. Thus, for 1998, there is no net increase with respect to D because the amount of the items provided in section 1367(a)(1) do not exceed the amount of the items provided in section 1367(a)(2).

(ii) Because there is no net increase with respect to D for 1998, none of the 1997 reduction in D's basis in the indebtedness is restored. The $10,000 increase in basis under section 1367(a)(1) is applied to increase D's basis in his S stock. Under section 1367(a)(2)(A), the $11,000 distribution with respect to D's stock reduces D's basis in his shares of S stock to $0. See section 1368 and § 1.1368–1 (c) and (d) for the tax treatment of the $1,000 distribution in excess of D's basis.

Example 5. Distributions less than increase in basis. (i) The facts are the same as in *Example 4,* except that in 1998 S makes distributions to D totaling $8,000. On these facts, for 1998, there is a net increase with respect to D of $2,000 (the amount by which the items provided in section 1367(a)(1) exceed the amount of the items provided in section 1367(a)(2)).

(ii) Because there is a net increase of $2,000 with respect to D for 1998, $2,000 of the $10,000 increase in basis under section 1367(a)(1) is first applied to restore D's basis in the indebtedness to $10,000 ($8,000 + $2,000). Accordingly, on December 31, 1998, D has a basis in his shares of S stock of $0 ($0 + $8,000 (increase in basis remaining after restoring basis in indebtedness)—$8,000 (distribution)) and a basis in the note of $10,000.

Example 6. The $25,000 aggregate principal amount applies to each shareholder. (i) A and B have been the two shareholders in Corporation S since 2000. As of the end of the 2008 taxable year, the bases of A's and B's stock are both zero. On June 1, 2009, A advances S $16,000, which is not evidenced by a written instrument. On August 1, 2009, B advances S $22,000, which is not evidenced by a written instrument. Both the $16,000 advance and the $22,000 advance are open account debt and remain outstanding at those amounts during 2009. There is no net increase under paragraph (c) of this section in year 2009.

(ii) At the close of the 2009 taxable year, A's open account debt does not exceed $25,000. A therefore carries forward to the beginning of the 2010 taxable year the $16,000 as open account debt.

(iii) At the close of the 2009 taxable year, B's open account debt does not exceed $25,000. B therefore carries forward to the beginning of the 2010 taxable year the $22,000 as open account debt.

Example 7. Treatment of open account debt. (i) The facts are the same as in *Example 6*, in addition to which, on December 31, 2009, A's basis in the open account debt is reduced under paragraph (b) of this section to $8,000. On April 1, 2010, S repays A $4,000 of the open account indebtedness. On September 1, 2010, A advances S an additional $1,000, which is not evidenced by a written instrument. There is no net increase under paragraph (c) of this section in year 2010.

(ii) The $4,000 April repayment S makes to A and A's $1,000 September advance are netted to result in a net repayment of $3,000 for the taxable year on A's $16,000 open account debt carried forward from 2009. Because there is no net increase in 2010, no basis of indebtedness is restored for the 2010 taxable year, and A realizes $1,500 of income on the $3,000 net repayment at the close of the 2010 taxable year.

(iii) At close of the 2010 taxable year, A's open account debt does not exceed $25,000. The net repayment of $3,000 for the taxable year on A's $16,000 open account debt carried forward from 2009, leaves A with an open account debt of $13,000 to carry forward as open account debt to the beginning of the 2011 taxable year.

Example 8. Treatment of shareholder indebtedness not evidenced by a written instrument which exceeds $25,000. (i) The facts are the same as in *Example 7*, in addition to which, on February 1, 2011, S repays $5,000 of the open account debt and on March 1, 2011, A advances S $20,000, which is not evidenced by a written instrument.

(ii) At the close of the 2010 taxable year, A has an open account debt of $13,000 to carry forward as open account debt to the beginning of the 2011 taxable year.

(iii) The 2011 advances and repayments are netted to result in a net advance of $15,000 on A's $13,000 open account debt carried forward from 2010, increasing A's open account debt to $28,000 as of the close of the 2011 taxable year. Because A's open account debt exceeds $25,000, for any subsequent taxable year the $28,000 indebtedness will be treated in the same manner as indebtedness evidenced by a separate written instrument for the purposes of this section. Because there is no net increase in 2011, no basis of indebtedness is restored for the 2011 taxable year.

[T.D. 8508, 59 FR 16, Jan. 3, 1994, as amended by T.D. 9428, 73 FR 62202, Oct. 20, 2008; T.D. 9428, 73 FR 67389, Nov. 14, 2008; T.D. 9428, 73 FR 71545, Nov. 25, 2008]

§ 1.1367–3 Effective/Applicability date.

Section 1.1367–2(a), (c)(2), (d)(2), and (e) *Example 6*, *Example 7*, and *Example 8* apply to any shareholder advances to the S corporation made on or after October 20, 2008 and repayments on those advances by the S corporation. The rules that apply with respect to shareholder advances to the S corporation made before October 20, 2008, are contained in § 1.1367–3 in effect prior to October 20, 2008. (See 26 CFR part 1 revised as of April 1, 2007.) Shareholders have the option to apply these rules to shareholder advances to the S corporation made before October 20, 2008, and repayments on those advances by the S corporation. Section 1.1367–1(h), *Example 5*(iii) applies on and after July 23, 2014. The rules that apply before July 23, 2014 are contained in § 1.1367–3 in effect prior to July 23, 2014 (see 26 CFR part 1 revised as of April 1, 2014).

[T.D. 9428, 73 FR 62203, Oct. 20, 2008, as amended by T.D. 9682, 79 FR 42678, July 23, 2014]

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§ 1.1368–3 Examples.

§ 1.1368–4 Effective date and transition rule.

[T.D. 8508, 59 FR 18, Jan. 3, 1994, as amended by T.D. 8696, 61 FR 67455, Dec. 23, 1996; T.D. 8852, 64 FR 71649, Dec. 22, 1999; T.D. 8869, 65 FR 3855, Jan. 25, 2000]

§ 1.1368–1 Distributions by S corporations.

(a) *In general.* This section provides rules for distributions made by an S corporation with respect to its stock which, but for section 1368(a) and this section, would be subject to section 301(c) and other rules of the Internal Revenue Code that characterize a distribution as a dividend.

(b) *Date distribution made.* For purposes of section 1368, a distribution is taken into account on the date the corporation makes the distribution, regardless of when the distribution is treated as received by the shareholder.

(c) *S corporation with no earnings and profits.* A distribution made by an S corporation that has no accumulated earnings and profits as of the end of the taxable year of the S corporation in which the distribution is made is treated in the manner provided in section 1368(b).

(d) *S corporation with earnings and profits*—(1) *General treatment of distribution.* Except as provided in paragraph (d)(2) of this section, a distribution made with respect to its stock by an S corporation that has accumulated earnings and profits as of the end of the taxable year of the S corporation in which the distribution is made is treated in the manner provided in section 1368(c). See section 316 and § 1.316–2 for provisions relating to the allocation of earnings and profits among distributions.

(2) *Previously taxed income.* This paragraph (d)(2) applies to distributions by a corporation that has both accumulated earnings and profits and previously taxed income (within the meaning of section 1375(d)(2), as in effect prior to its amendment by the Subchapter S Revision Act of 1982, and the regulations thereunder) with respect to one or more shareholders. In the case of such a distribution, that portion remaining after the application of section 1368(c)(1) (relating to distributions from the accumulated adjustments account (AAA) as defined in § 1.1368–2(a)) is treated in the manner provided in section 1368(b) (relating to S corporations without earnings and profits) to the extent that portion is a

distribution of money and does not exceed the shareholder's net share immediately before the distribution of the corporation's previously taxed income. The AAA and the earnings and profits of the corporation are not decreased by that portion of the distribution. Any distribution remaining after the application of this paragraph (d)(2) is treated in the manner provided in section 1368(c) (2) and (3).

(e) *Certain adjustments taken into account*—(1) *Taxable years beginning before January 1, 1997.* For any taxable year of the corporation beginning before January 1, 1997, paragraphs (c) and (d) of this section are applied only after taking into account—

(i) The adjustments to the basis of the shares of a shareholder's stock described in section 1367 (without regard to section 1367(a)(2)(A) (relating to decreases attributable to distributions not includible in income)) for the S corporation's taxable year; and

(ii) The adjustments to the AAA required by section 1368(e)(1)(A) (but without regard to the adjustments for distributions under §1.1368–2(a)(3)(iii)) for the S corporation's taxable year.

(2) *Taxable years beginning on or after August 18, 1998.* For any taxable year of the corporation beginning on or after August 18, 1998, paragraphs (c) and (d) of this section are applied only after taking into account—

(i) The adjustments to the basis of the shares of a shareholder's stock described in section 1367(a)(1) (relating to increases in basis of stock) for the S corporation's taxable year; and

(ii) The adjustments to the AAA required by section 1368(e)(1)(A) (but without regard to the adjustments for distributions under §1.1368–2(a)(3)(iii)) for the S corporation's taxable year. Any net negative adjustment (as defined in section 1368(e)(1)(C)(ii)) for the taxable year shall not be taken into account.

(f) *Elections relating to source of distributions*—(1) *In general.* An S corporation may modify the application of paragraphs (c) and (d) of this section by electing (pursuant to paragraph (f)(5) of this section)—

(i) To distribute earnings and profits first as described in paragraph (f)(2) of this section;

(ii) To make a deemed dividend as described in paragraph (f)(3) of this section; or

(iii) To forego previously taxed income as described in paragraph (f)(4) of this section.

(2) *Election to distribute earnings and profits first*—(i) *In general.* An S corporation with accumulated earnings and profits may elect under this paragraph (f)(2) for any taxable year to distribute earnings and profits first as provided in section 1368(e)(3). Except as provided in paragraph (f)(2)(ii) of this section, distributions made by an S corporation making this election are treated as made first from earnings and profits under section 1368(c)(2) and second from the AAA under section 1368(c)(1). Any remaining portion of the distribution is treated in the manner provided in section 1368(b). This election is effective for all distributions made during the year for which the election is made.

(ii) *Previously taxed income.* If a corporation to which paragraph (d)(2) of this section (relating to corporations with previously taxed income) applies makes the election provided in this paragraph (f)(2) for the taxable year, and does not make the election to forego previously taxed income under paragraph (f)(4) of this section, distributions by the S corporation during the taxable year are treated as made first, from previously taxed income under paragraph (d)(2) of this section; second, from earnings and profits under section 1368(c)(2); and third, from the AAA under section 1368(c)(1). Any portion of a distribution remaining after the previously taxed income, earnings and profits, and the AAA are exhausted is treated in the manner provided in section 1368(b).

(iii) *Corporation with subchapter C and subchapter S earnings and profits.* If an S corporation that makes the election provided in this paragraph (f)(2) has both subchapter C earnings and profits (as defined in section 1362(d)(3)(B)) and subchapter S earnings and profits in a taxable year of the corporation in which the distribution is made, the distribution is treated as made first from subchapter C earnings and profits, and second from subchapter S earnings and

profits. *Subchapter S earnings and profits* are earnings and profits accumulated in a taxable year beginning before January 1, 1983 (or in the case of a qualified casualty insurance electing small business corporation or a qualified oil corporation, earnings and profits accumulated in any taxable year), for which an election under subchapter S of chapter 1 of the Internal Revenue Code was in effect.

(3) *Election to make a deemed dividend.* An S corporation may elect under this paragraph (f)(3) to distribute all or part of its subchapter C earnings and profits through a deemed dividend. If an S corporation makes the election provided in this paragraph (f)(3), the S corporation will be considered to have made the election provided in paragraph (f)(2) of this section (relating to the election to distribute earnings and profits first). The amount of the deemed dividend may not exceed the subchapter C earnings and profits of the corporation on the last day of the taxable year, reduced by any actual distributions of subchapter C earnings and profits made during the taxable year. The amount of the deemed dividend is considered, for all purposes of the Internal Revenue Code, as if it were distributed in money to the shareholders in proportion to their stock ownership, received by the shareholders, and immediately contributed by the shareholders to the corporation, all on the last day of the corporation's taxable year.

(4) *Election to forego previously taxed income.* An S corporation may elect to forego distributions of previously taxed income. If such an election is made, paragraph (d)(2) of this section (relating to corporations with previously taxed income) does not apply to any distribution made during the taxable year. Thus, distributions by a corporation that makes the election to forego previously taxed income for a taxable year under this paragraph (f)(4) and does not make the election to distribute earnings and profits first under paragraph (f)(2) of this section are treated in the manner provided in section 1368(c) (relating to distributions by corporations with earnings and profits). Distributions by a corporation that makes both the election to distribute earnings and profits first under paragraph (f)(2) of this section and the election to forego previously taxed income under this paragraph (f)(4), are treated in the manner provided in paragraph (f)(2)(i) of this section.

(5) *Time and manner of making elections*—(i) *For earnings and profits.* If an election is made under paragraph (f)(2) of this section to distribute earnings and profits first, see section 1368(e)(3) regarding the consent required by shareholders.

(ii) *For previously taxed income and deemed dividends.* If an election is made to forego previously taxed income under paragraph (f)(4) of this section or to make a deemed dividend under paragraph (f)(3) of this section, consent by each ''affected shareholder,'' as defined in section 1368(e)(3)(B), is required.

(iii) *Corporate statement regarding elections.* A corporation makes an election for a taxable year under §1.1368–1(f) by attaching a statement to a timely filed (including extensions) original or amended return required to be filed under section 6037 for that taxable year. In the statement, the corporation must identify the election it is making under §1.1368–1(f) and must state that each shareholder consents to the election. In the case of elections for taxable years beginning before January 1, 2003, an officer of the corporation must sign under penalties of perjury the statement on behalf of the corporation. In the case of elections for taxable years beginning after December 31, 2002, the statement described in this paragraph (f)(5)(iii) shall be verified by signing the return. A statement of election to make a deemed dividend under §1.1368–1(f) must include the amount of the deemed dividend that is distributed to each shareholder.

(iv) *Irrevocable elections.* The elections under this paragraph (f) are irrevocable and are effective only for the taxable year for which they are made. In applying the preceding sentence to elections under this paragraph (f), an election to terminate the taxable year under section 1377(a)(2) or §1.1368–1(g)(2) is disregarded.

(g) *Special rule*—(1) *Election to terminate year under §1.1368–1(g)(2).* If an election is made under paragraph (g)(2) of this section to terminate the year

when there is a qualifying disposition, this section applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which there is a qualifying disposition of stock.

(2) *Election in case of a qualifying disposition*—(i) *In general.* In the case of a qualifying disposition, a corporation may elect under this paragraph (g)(2)(i) to treat the year as if it consisted of separate taxable years, the first of which ends at the close of the day on which the qualifying disposition occurs. A *qualifying disposition* is—

(A) A disposition by a shareholder of 20 percent or more of the outstanding stock of the corporation in one or more transactions during any thirty-day period during the corporation's taxable year;

(B) A redemption treated as an exchange under section 302(a) or section 303(a) of 20 percent or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any thirty-day period during the corporation's taxable year; or

(C) An issuance of an amount of stock equal to or greater than 25 percent of the previously outstanding stock to one or more new shareholders during any thirty-day period during the corporation's taxable year.

(ii) *Effect of the election.* A corporation making an election under paragraph (g)(2)(i) of this section must treat the taxable year as separate taxable years for purposes of allocating items of income and loss; making adjustments to the AAA, earnings and profits, and basis; and determining the tax effect of distributions under section 1368 (b) and (c). An election made under paragraph (g)(2)(i) of this section may be made upon the occurrence of any qualifying disposition. Dispositions of stock that are taken into account as part of a qualifying disposition are not taken into account in determining whether a subsequent qualifying disposition has been made. In the case of a taxable year for which an election is made under paragraph (g)(2)(i), for purposes of section 163(j), a separate section 163(j) limitation (as defined in §1.163(j)–1(b)(36)) applies to each separate taxable year. Any items necessary to determine the amount of business interest expense (as defined in §1.163(j)–1(b)(3)) that are deducted in each separate taxable year must be allocated between the two separate taxable years in accordance with an allocation methodology provided in this paragraph (g).

(iii) *Time and manner of making election.* A corporation makes an election under §1.1368–1(g)(2)(i) for a taxable year by attaching a statement to a timely filed (including extensions) original or amended return required to be filed under section 6037 for a taxable year (without regard to the election under §1.1368–1(g)(2)(i)). In the statement, the corporation must state that it is electing for the taxable year under §1.1368–1(g)(2)(i) to treat the taxable year as if it consisted of separate taxable years. The corporation also must set forth facts in the statement relating to the qualifying disposition (*e.g.*, sale, gift, stock issuance, or redemption), and state that each shareholder who held stock in the corporation during the taxable year (without regard to the election under §1.1368–1(g)(2)(i)) consents to this election. For purposes of this election, a shareholder of the corporation for the taxable year is a shareholder as described in section 1362(a)(2). A single election statement may be filed for all elections made under §1.1368–1(g)(2)(i) for the taxable year. An election made under §1.1368–1(g)(2)(i) is irrevocable. In the case of elections for taxable years beginning before January 1, 2003, the statement through which a corporation makes an election under §1.1368–1(g)(2)(i) must be signed by an officer of the corporation under penalties of perjury. In the case of elections for taxable years beginning after December 31, 2002, the statement described in the preceding sentence shall be verified by signing the return.

(iv) *Coordination with election under section 1377(a)(2).* If the event resulting in a qualifying disposition also results in a termination of a shareholder's entire interest as described in §1.1377–1(b)(4), the election under this paragraph (g)(2) cannot be made. Rather, the election under section 1377(a)(2) and §1.1377–1(b) may be made. See

§ 1.1377–1(b) (concerning the election under section 1377(a)(2)).

[T.D. 8508, 59 FR 19, Jan. 3, 1994, as amended by T.D. 8696, 61 FR 67455, Dec. 23, 1996; T.D. 8852, 64 FR 71650, Dec. 22, 1999; T.D. 9100, 68 FR 70706, Dec. 19, 2003; T.D. 9300, 71 FR 71043, Dec. 8, 2006; T.D. 9905, 85 FR 56842, Sept. 14, 2020]

§ 1.1368–2 Accumulated adjustments account (AAA).

(a) *Accumulated adjustments account*—(1) *In general.* The accumulated adjustments account is an account of the S corporation and is not apportioned among shareholders. The AAA is relevant for all taxable years beginning on or after January 1, 1983, for which the corporation is an S corporation. On the first day of the first year for which the corporation is an S corporation, the balance of the AAA is zero. The AAA is increased in the manner provided in paragraph (a)(2) of this section and is decreased in the manner provided in paragraph (a)(3) of this section. For the adjustments to the AAA in the case of redemptions, liquidations, reorganizations, and corporate separations, see paragraph (d) of this section.

(2) *Increases to the AAA.* The AAA is increased for the taxable year of the corporation by the sum of the following items with respect to the corporation for the taxable year:

(i) The items of income described in section 1366(a)(1)(A) other than income that is exempt from tax;

(ii) Any nonseparately computed income determined under section 1366(a)(1)(B); and

(iii) The excess of the deductions for depletion over the basis of property subject to depletion unless the property is an oil or gas property the basis of which has been allocated to shareholders under section 613A(c)(11).

(3) *Decreases to the AAA*—(i) *In general.* The AAA is decreased for the taxable year of the corporation by the sum of the following items with respect to the corporation for the taxable year—

(A) The items of loss or deduction described in section 1366(a)(1)(A);

(B) Any nonseparately computed loss determined under section 1366(a)(1)(B);

(C) Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account, other than—

(*1*) Federal taxes attributable to any taxable year in which the corporation was a C corporation; and

(*2*) Expenses related to income that is exempt from tax; and

(D) The sum of the shareholders' deductions for depletion for any oil or gas property held by the corporation described in section 1367(a)(2)(E).

(ii) *Extent of allowable reduction.* The AAA may be decreased under paragraph (a)(3)(i) of this section below zero. The AAA is decreased by noncapital, nondeductible expenses under paragraph (a)(3)(i)(C) of this section even though a portion of the noncapital, nondeductible expenses is not taken into account by a shareholder under § 1.1367–1(g) (relating to the elective ordering rule). The AAA is also decreased by the entire amount of any loss or deduction even though a portion of the loss or deduction is not taken into account by a shareholder under section 1366(d)(1) or is otherwise not currently deductible under the Internal Revenue Code. However, in any subsequent taxable year in which the loss, deduction, or noncapital, nondeductible expense is treated as incurred by the corporation with respect to the shareholder under section 1366(d)(2) or § 1.1367–1(g) (or in which the loss or deduction is otherwise allowed to the shareholder), no further adjustment is made to the AAA.

(iii) *Decrease to the AAA for distributions.* The AAA is decreased (but not below zero) by any portion of a distribution to which section 1368 (b) or (c)(1) applies.

(4) *Ordering rules for the AAA for taxable years beginning before January 1, 1997.* For any taxable year beginning before January 1, 1997, the adjustments to the AAA are made in the following order—

(i) The AAA is increased under paragraph (a)(2) of this section before it is decreased under paragraph (a)(3) of this section for the taxable year;

(ii) The AAA is decreased under paragraph (a)(3)(i) of this section before it is decreased under paragraph (a)(3) (iii) of this section;

(iii) The AAA is decreased (but not below zero) by any portion of an ordinary distribution to which section 1368 (b) or (c)(1) applies; and

(iv) The AAA is adjusted (whether negative or positive) for redemption distributions under paragraph (d)(1) of this section.

(5) *Ordering rules for the AAA for taxable years beginning on or after August 18, 1998.* For any taxable year of the S corporation beginning on or after August 18, 1998, the adjustments to the AAA are made in the following order—

(i) The AAA is increased under paragraph (a)(2) of this section before it is decreased under paragraph (a)(3)(i) of this section for the taxable year;

(ii) The AAA is decreased under paragraph (a)(3)(i) of this section (without taking into account any net negative adjustment (as defined in section 1368(e)(1)(C)(ii)) before it is decreased under paragraph (a)(3)(iii) of this section;

(iii) The AAA is decreased (but not below zero) by any portion of an ordinary distribution to which section 1368(b) or (c)(1) applies;

(iv) The AAA is decreased by any net negative adjustment (as defined in section 1368(e)(1)(C)(ii)); and

(v) The AAA is adjusted (whether negative or positive) for redemption distributions under paragraph (d)(1) of this section.

(b) *Distributions in excess of the AAA*—(1) *In general.* A portion of the AAA (determined under paragraph (b)(2) of this section) is allocated to each of the distributions made for the taxable year if—

(i) An S corporation makes more than one distribution of property with respect to its stock during the taxable year of the corporation (including an S short year as defined under section 1362(e)(1)(A));

(ii) The AAA has a positive balance at the close of the year; and

(iii) The sum of the distributions made during the corporation's taxable year exceeds the balance of the AAA at the close of the year.

(2) Amount of the AAA allocated to each distribution. The amount of the AAA allocated to each distribution is determined by multiplying the balance of the AAA at the close of the current taxable year by a fraction, the numerator of which is the amount of the distribution and the denominator of which is the amount of all distributions made during the taxable year. For purposes of this paragraph (b)(2), the term *all distributions made during the taxable year* does not include any distribution treated as from earnings and profits or previously taxed income pursuant to an election made under section 1368(e)(3) and § 1.1368–1(f)(2). See paragraph (d)(1) of this section for rules relating to the adjustments to the AAA for redemptions and distributions in the year of a redemption.

(c) *Distribution of money and loss property*—(1) *In general.* The amount of the AAA allocated to a distribution under this section must be further allocated (under paragraph (c)(2) of this section) if the distribution—

(i) Consists of property the adjusted basis of which exceeds its fair market value on the date of the distribution and money;

(ii) Is a distribution to which § 1.1368–1(d)(1) applies; and

(iii) Exceeds the amount of the corporation's AAA properly allocable to that distribution.

(2) *Allocating the AAA to loss property.* The amount of the AAA allocated to the property other than money is equal to the amount of the AAA allocated to the distribution multiplied by a fraction, the numerator of which is the fair market value of the property other than money on the date of distribution and the denominator of which is the amount of the distribution. The amount of the AAA allocated to the money is equal to the amount of the AAA allocated to the distribution reduced by the amount of the AAA allocated to the property other than money.

(d) *Adjustment in the case of redemptions, liquidations, reorganizations, and divisions*—(1) *Redemptions*—(i) *General rule.* In the case of a redemption distribution by an S corporation that is treated as an exchange under section 302(a) or section 303(a) (a *redemption distribution*), the AAA of the corporation is adjusted in an amount equal to the ratable share of the corporation's AAA

(whether negative or positive) attributable to the redeemed stock as of the date of the redemption.

(ii) *Special rule for years in which a corporation makes both ordinary and redemption distributions.* In any year in which a corporation makes one or more distributions to which section 1368(a) applies (*ordinary distributions*) and makes one or more redemption distributions, the AAA of the corporation is adjusted first for any ordinary distributions and then for any redemption distributions.

(iii) *Adjustments to earnings and profits.* Earnings and profits are adjusted under section 312 independently of any adjustments made to the AAA.

(2) *Liquidations and reorganizations.* An S corporation acquiring the assets of another S corporation in a transaction to which section 381(a) applies will succeed to and merge its AAA (whether positive or negative) with the AAA (whether positive or negative) of the distributor or transferor S corporation as of the close of the date of distribution or transfer. Thus, the AAA of the acquiring corporation after the transaction is the sum of the AAAs of the corporations prior to the transaction.

(3) *Corporate separations to which section 368(a)(l)(D) applies.* If an S corporation with accumulated earnings and profits transfers a part of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(l)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, the AAA of the distributing corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation in a manner similar to the manner in which the earnings and profits of the distributing corporation are allocated under section 312 (h). See § 1.312–10(a).

(e) *Election to terminate year under section 1377(a)(2) or § 1.1368–1(g)(2).* If an election is made under section 1377(a)(2) (to terminate the year in the case of termination of a shareholder's interest) or § 1.1368–1(g)(2) (to terminate the year in the case of a qualifying disposition), this section applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which the shareholder terminated his or her interest in the corporation or makes a substantial disposition of stock, whichever the case may be.

[T.D. 8508, 59 FR 20, Jan. 3, 1994, as amended by T.D. 8852, 64 FR 71650, Dec. 22, 1999; T.D. 8869, 65 FR 3855, Jan. 25, 2000]

§ 1.1368–3 Examples.

The principles of §§ 1.1368–1 and 1.1368–2 are illustrated by the examples below. In each example Corporation S is a calendar year corporation:

Example 1. Distributions by S corporations without C corporation earnings and profits for taxable years beginning before January 1, 1997. (i) Corporation S, an S corporation, has no earnings and profits as of January 1, 1996, the first day of its 1996 taxable year. S's sole shareholder, A, holds 10 shares of S stock with a basis of $1 per share as of that date. On March 1, 1996, S makes a distribution of $38 to A. For S's 1996 taxable year, A's pro rata share of the amount of the items described in section 1367(a)(1) (relating to increases in basis of stock) is $50 and A's pro rata share of the amount of the items described in section 1367(a)(2) (B) through (D) (relating to decreases in basis of stock for items other than distributions) is $26.

(ii) Under section 1368(d)(1) and § 1.1368–1(e)(1), the adjustments to the bases of A's stock in S described in section 1367 are made before the distribution rules of section 1368 are applied. Thus, A's basis per share in the stock is $3.40 ($1 + [($50–$26) / 10 shares]) before taking into account the distribution. Under section 1367(a)(2)(A), the basis of A's stock is decreased by distributions to A that are not includible in A's income. Under § 1.1367–1(c)(3), the amount of the distribution that is attributable to each share of A's stock is $3.80 ($38 distribution / 10 shares). However, A only has a basis of $3.40 in each share, and basis may not be reduced below zero. Therefore, the basis of each share of his stock is reduced by $3.40 to zero, and the remaining $4.00 of the distribution ([$3.80–$3.40] × 10 shares) is treated as gain from the sale or exchange of property. As of January 1, 1997, A has a basis of $0 in his shares of S stock.

Example 2. Distributions by S corporations without earnings and profits for taxable years beginning on or after August 18, 1998. (i) Corporation S, an S corporation, has no earnings and profits as of January 1, 2001, the first day of its 2001 taxable year. S's sole

shareholder, A, holds 10 shares of S stock with a basis of $1 per share as of that date. On March 1, 2001, S makes a distribution of $38 to A. The balance in Corporation S's AAA is $100. For S's 2001 taxable year, A's pro rata share of the amount of the items described in section 1367(a)(1) (relating to increases in basis of stock) is $50. A's pro rata share of the amount of the items described in sections 1367(a)(2)(B) through (D) (relating to decreases in basis of stock for items other than distributions) is $26, $20 of which is attributable to items described in section 1367(a)(2)(B) and (C) and $6 of which is attributable to items described in section 1367(a)(2)(D) (relating to decreases in basis attributable to noncapital, nondeductible expenses).

(ii) Under section 1368(d)(1) and §1.1368–1(e)(1) and (2), the adjustments to the basis of A's stock in S described in sections 1367(a)(1) are made before the distribution rules of section 1368 are applied. Thus, A's basis per share in the stock is $6.00 ($1 + [$50/10]) before taking into account the distribution. Under section 1367(a)(2)(A), the basis of A's stock is decreased by distributions to A that are not includible in A's income. Under §1.1367–1(c)(3), the amount of the distribution that is attributable to each share of A's stock is $3.80 ($38 distribution/10 shares). Thus, A's basis per share in the stock is $2.20 ($6.00–$3.80), after taking into account the distribution. Under section 1367(a)(2)(D), the basis of each share of A's stock in S after taking into account the distribution, $2.20, is decreased by $.60 ($6 noncapital, nondeductible expenses/10). Thus, A's basis per share after taking into account the nondeductible, noncapital expenses is $1.60. Under section 1367(a)(2)(B) and (C), A's basis per share is further decreased by $2 ($20 items described in section 1367(a)(2)(B) and (C)/10 shares). However, basis may not be reduced below zero. Therefore, the basis of each share of A's stock is reduced to zero. As of January 1, 2002, A has a basis of $0 in his shares of S stock. Pursuant to section 1366(d)(2), the $.40 of loss in excess of A's basis in each of his shares of S stock is treated as incurred by the corporation in the succeeding taxable year with respect to A.

Example 3. Distributions by S corporations with C corporation earnings and profits for taxable years beginning before January 1, 1997. (i) Corporation S properly elects to be an S corporation beginning January 1, 1997, and as of that date has accumulated earnings and profits of $30. B, an individual and sole shareholder of Corporation S, has 10 shares of S stock with a basis of $12 per share. In addition, B lends $30 to S evidenced by a demand note.

(ii) During 1997, S has a nonseparately computed loss of $150. S makes no distributions to B during 1997. Under section 1366(d)(1), B is allowed a loss equal to $150, the amount equal to the sum of B's bases in his shares of stock and his basis in the debt. Under section 1367, the loss reduces B's adjusted basis in his stock and debt to $0. Under §1.1368–2(a)(3), S's AAA as of December 31, 1997, has a deficit of $150 as a result of S's loss for the year.

(iii) For 1998, S has $220 of separately stated income and distributes $110 to B. The balance in the AAA (negative $150 from 1997) is increased by $220 for S's income for the year and decreased to $0 for the portion of the distribution that is treated as being from the AAA ($70). Under §1.1367–2(c), B's net increase is $150, determined by reducing the $220 of income by the $70 of the distribution not includible in income by B. Thus, B's basis in the debt is fully restored to $30, and B's basis in S stock (before accounting for the distribution) is increased from zero to $19 per share ([$220–$30 applied to the debt] / 10). Thirty dollars of the distribution is considered a dividend to the extent of S's $30 of earnings and profits, and the remaining $10 of the distribution reduces B's basis in the S stock. Thus, B's basis in the S stock as of December 31, 1998, is $11 per share ($19–[$70 AAA distribution / 10]–[10 distribution treated as a reduction in basis / 10]). The balance in the AAA is $0, S's earnings and profits are $0, and B's basis in the loan is $30.

Example 4. Distributions by S corporations with earnings and profits and no net negative adjustment for taxable years beginning on or after August 18, 1998. (i) Corporation S, an S corporation, has accumulated earnings and profits of $1,000 and a balance in the AAA of $2,000 on January 1, 2001. S's sole shareholder B holds 100 shares of stock with a basis of $20 per share as of January 1, 2001. On April 1, 2001, S makes a distribution of $1,500 to B. B's pro rata share of the income earned by S during 2001 is $2,000 and B's pro rata share of S's losses is $1,500. For the taxable year ending December 31, 2001, S does not have a net negative adjustment as defined in section 1368(e)(1)(C). S does not make the election under section 1368(e)(3) and §1.1368–1(f)(2) to distribute its earnings and profits before its AAA.

(ii) The AAA is increased from $2,000 to $4,000 for the $2,000 of income earned during the 2001 taxable year. The AAA is decreased from $4,000 to $2,500 for the $1,500 of losses. The AAA is decreased from $2,500 to $1,000 for the portion of the distribution ($1,500) to B that does not exceed the AAA.

(iii) As of December 31, 2001, B's basis in his stock is $10 ($20 + $20 ($2,000 income/100 shares)—$15 ($1,500 distribution/100 shares)—$15 ($1,500 loss/100 shares).

Example 5. Distributions by S corporations with earnings and profits and net negative adjustment for taxable years beginning on or after August 18, 1998. (i) Corporation S, an S corporation, has accumulated earnings and profits of $1,000 and a balance in the AAA of

$2,000 on January 1, 2001. S's sole shareholder B holds 100 shares of stock with a basis of $20 per share as of January 1, 2001. On April 1, 2001, S makes a distribution of $2,000 to B. B's pro rata share of the income earned by S during 2001 is $2,000 and B's pro rata share of S's losses is $3,500. For the taxable year ending December 31, 2001, S has a net negative adjustment as defined in section 1368(e)(1)(C). S does not make the election under section 1368(e)(3) and §1.1368–1(f)(2) to distribute its earnings and profits before its AAA.

(ii) The AAA is increased from $2,000 to $4,000 for the $2,000 of income earned during the 2001 taxable year. Because under section 1368(e)(1)(C)(ii) and §1.1368–2(a)(ii), the net negative adjustment is not taken into account, the AAA is decreased from $4,000 to $2,000 for the portion of the losses ($2,000) that does not exceed the income earned during the 2001 taxable year. The AAA is reduced from $2,000 to zero for the portion of the distribution to B ($2,000) that does not exceed the AAA. The AAA is decreased from zero to a negative $1,500 for the portion of the $3,500 of loss that exceeds the $2,000 of income earned during the 2001 taxable year.

(iii) Under §1.1367–1(c)(1), the basis of a shareholder's share in an S corporation stock may not be reduced below zero. Accordingly, as of December 31, 2001, B's basis per share in his stock is zero ($20 + $20 income—$20 distribution—$35 loss). Pursuant to section 1366(d)(2), the $15 of loss in excess of B's basis in each of his shares of S stock is treated as incurred by the corporation in the succeeding taxable year with respect to B.

Example 6. Election in case of disposition of substantial amount of stock. (i) Corporation S, an S corporation, has earnings and profits of $3,000 and a balance in the AAA of $1,000 on January 1, 1997. C, an individual and the sole shareholder of Corporation S, has 100 shares of S stock with a basis of $10 per share. On July 3, 1997, C sells 50 shares of his S stock to D, an individual, for $250. For 1997, S has taxable income of $1,000, of which $500 was earned on or before July 3, 1997, and $500 earned after July 3, 1997. During its 1997 taxable year, S distributes $1,000 to C on February 1 and $1,000 to each of C and D on August 1. S does not make the election under section 1368(e)(3) and §1.1368–1(f)(2) to distribute its earnings and profits before its AAA. S makes the election under §1.1368–1(g)(2) to treat its taxable year as if it consisted of separate taxable years, the first of which ends at the close of July 3, 1997, the date of the qualifying disposition.

(ii) Under section §1.1368–1(g)(2), for the period ending on July 3, 1997, S's AAA is $500 ($1,000 (AAA as of January 1, 1997) + $500 (income earned from January 1, 1997 through July 3, 1997)–$1,000 (distribution made on February 1, 1997)). C's bases in his shares of stock is decreased to $5 per share ($10 (original basis) + $5 (increase per share for income)–$10 (decrease per share for distribution)).

(iii) The AAA is adjusted at the end of the taxable year for the period July 4 through December 31, 1997. It is increased from $500 (AAA as of the close of July 3, 1997) to $1,000 for the income earned during this period and is decreased by $1,000, the portion of the distribution ($2,000 in total) made to C and D on August 1 that does not exceed the AAA. The $1,000 portion of the distribution that remains after the AAA is reduced to zero is attributable to earnings and profits. Therefore C and D each have a dividend of $500, which does not affect their basis or S's AAA. The earnings and profits account is reduced from $3,000 to $2,000.

(iv) As of December 31, 1997, C and D have bases in their shares of stock of zero ($5 (basis as of July 4) + $5 ($500 income/100 shares)–$10 ($1,000 distribution/100 shares)). C and D each will report $500 as dividend income, which does not affect their basis or S's AAA.

Example 7. Election to distribute earnings and profits first. (i) Corporation S has been a calendar year C corporation since 1975. For 1982, S elects for the first time to be taxed under subchapter S, and during 1982 has $60 of earnings and profits. As of December 31, 1995, S has an AAA of $10 and earnings and profits of $160, consisting of $100 of subchapter C earnings and profits and $60 of subchapter S earnings and profits. For 1996, S has $200 of taxable income and the AAA is increased to $210 (before taking distributions into account). During 1996, S distributes $240 to its shareholders. With its 1996 tax return, S properly elects under section 1368(e)(3) and §1.1368–1(f)(2) to distribute its earnings and profits before its AAA.

(ii) Because S elected to distribute its earnings and profits before its AAA, the first $100 of the distribution is characterized as a distribution from subchapter C earnings and profits; the next $60 of the distribution is characterized as a distribution from subchapter S earnings and profits. Because $160 of the distribution is from earnings and profits, the shareholders of S have a $160 dividend. The remaining $80 of the distribution is a distribution from S's AAA and is treated by the shareholders as a return of capital or gain from the sale or exchange of property, as appropriate, under §1.1368–1(d)(1). S's AAA, as of December 31, 1996, equals $130 ($210–$80).

Example 8. Distributions in excess of the AAA. (i) On January 1, 1995, Corporation S has $40 of earnings and profits and a balance in the AAA of $100. S has two shareholders, E and F, each of whom own 50 shares of S's stock. For 1995, S has taxable income of $50, which increases the AAA to $150 as of December 31, 1995 (before taking into account distributions made during 1995). On February 1, 1995,

S distributes $60 to each shareholder. On September 1, 1995, S distributes $30 to each shareholder. S does not make the election under section 1368(e)(3) and § 1.1368–1(f)(2) to distribute its earnings and profits before its AAA.

(ii) The sum of the distributions exceed S's AAA. Therefore, under § 1.1368–2(b), a portion of S's $150 balance in the AAA as of December 31, 1995, is allocated to each of the February 1 and September 1 distributions based on the respective sizes of the distributions. Accordingly, S must allocate $100 ($150 (AAA) × ($120 (February 1 distribution)/$180 (the sum of the distributions))) of the AAA to the February 1 distribution, and $50 ($150 × ($60/$180)) to the September 1 distribution. The portions of the distributions to which the AAA is allocated are treated by the shareholder as a return of capital or gain from the sale or exchange of property, as appropriate. The remainder of the two distributions is treated as a dividend to the extent that it does not exceed S's earnings and profits. E and F must each report $10 of dividend income for the February 1 distribution. For the September 1 distribution, E and F must each report $5 of dividend income.

Example 9. Ordinary and redemption distributions in the same taxable year. (i) On January 1, 1995, Corporation S, an S corporation, has $20 of earnings and profits and a balance in the AAA of $10. S has two shareholders, G and H, each of whom owns 50 shares of S's stock. For 1995, S has taxable income of $16, which increases the AAA to $26 as of December 31, 1995 (before taking into account distributions made during 1995). On February 1, 1995, S distributes $10 to each shareholder. On December 31, 1995, S redeems for $13 all of shareholder G's stock in a redemption that is treated as a sale or exchange under section 302(a).

(ii) The sum of the ordinary distributions does not exceed S's AAA. Therefore, S must reduce the $26 balance in the AAA by $20 for the February 1 ordinary distribution. The portions of the distribution by which the AAA is reduced are treated by the shareholders as a return of capital or gain from the sale or exchange of property. S must adjust the remaining AAA, $6, in an amount equal to the ratable share of the remaining AAA attributable to the redeemed stock, or $3 (50% × $6).

(iii) S also must adjust the earnings and profits of $20 in an amount equal to the ratable share of the earnings and profits attributable to the redeemed stock. Therefore, S adjusts the earnings and profits by $10 (50% × $20), the ratable share of the earnings and profits attributable to the redeemed stock.

[T.D. 8508, 59 FR 22, Jan. 3, 1994; 59 FR 10675, Mar. 7, 1994, as amended by T.D. 8852, 64 FR 71650, Dec. 22, 1999]

§ 1.1368–4 Effective date and transition rule.

Except for §§ 1.1368–1(e)(2), 1.1368–2(a)(5), and 1.1368–3 *Example 2*, *Example 4*, and *Example 5*, §§ 1.1368–1, 1.1368–2, and 1.1368–3 apply to taxable years of the corporation beginning on or after January 1, 1994. Section 1.1368–1(e)(2), § 1.1368–2(a)(5), and § 1.1368–3 *Example 2*, *Example 4*, and *Example 5* apply only to taxable years of the corporation beginning on or after August 18, 1998. For taxable years beginning before January 1, 1994, and taxable years beginning on or after January 1, 1997, and before August 18, 1998, the treatment of distributions by an S corporation to its shareholders must be determined in a reasonable manner, taking into account the statute and legislative history. Except with regard to the deemed dividend rule under § 1.1368–1(f)(3), § 1.1368–1(e)(2), § 1.1368–2(a)(5), and § 1.1368–3 *Example 2*, *Example 4*, and *Example 5*, return positions consistent with §§ 1.1368–1, 1.1368–2, and 1.1368–3 are reasonable for taxable years beginning before January 1, 1994. Return positions consistent with §§ 1.1368–1(e)(2), 1.1368–2(a)(5), and 1.1368–3 *Example 2*, *Example 4*, and *Example 5* are reasonable for taxable years beginning on or after January 1, 1997, and before August 18, 1998.

[T.D. 8852, 64 FR 71651, Dec. 22, 1999]

§ 1.1371–1 Distributions of money by an eligible terminated S corporation.

(a) *Scope and definitions*—(1) *Scope.* This section provides rules relating to qualified distributions and distributions to which section 301 of the Internal Revenue Code (Code) applies during each taxable year of the ETSC period, including the taxable year in which the ETSC period ends. If an ETSC does not make any qualified distributions during a taxable year, then no distribution by the ETSC is governed by section 1371(f) of the Code or this section. Paragraph (a)(2) of this section contains definitions that apply for purposes of this section. Paragraph (b) of this section contains rules regarding the characterization of a qualified distribution. Paragraph (c) of this section contains rules regarding the characterization of any excess qualified distribution and non-qualified distribution during each

taxable year of the ETSC period, including the taxable year in which the ETSC period ends. Paragraph (d) of this section contains examples illustrating the rules of this section. Paragraph (e) of this section contains the applicability date of this section.

(2) *Definitions*. The following definitions apply for purposes of this section—

(i) *AAA*. The term *AAA* means the accumulated adjustments account, within the meaning of section 1368(e)(1)(A) of the Code and § 1.1368–2(a)(1).

(ii) *AAA ratio*. Except as provided in this paragraph or paragraph (b)(3)(iv) of this section, the term *AAA ratio* means the fraction of which the numerator is historical AAA and the denominator is the sum of historical AAA and historical AE&P. Notwithstanding the preceding sentence, if the AE&P of the ETSC is less than or equal to zero as of the beginning of a taxable year, then the AAA ratio is one for such year and for all subsequent taxable years of the ETSC period.

(iii) *AE&P*. The term *AE&P* means earnings and profits described in section 316(a)(1) of the Code.

(iv) *AE&P ratio*. Except as provided in this paragraph or paragraph (b)(3)(iv) of this section, the term *AE&P ratio* means the fraction of which the numerator is historical AE&P, and the denominator is the sum of historical AAA and historical AE&P. Notwithstanding the preceding sentence, if the AE&P of the ETSC is less than or equal to zero as of the beginning of a taxable year, then the AE&P ratio is zero for such year and all subsequent taxable years of the ETSC period.

(v) *CE&P*. The term *CE&P* means earnings and profits that are described in section 316(a)(2).

(vi) *ETSC*. The term *ETSC* means an eligible terminated S corporation, within the meaning of section 481(d) of the Code and § 1.481–5.

(vii) *ETSC period*. In general, the term *ETSC period* means any taxable year, or portion thereof, of an ETSC beginning on the first day after the post-termination period within the meaning of section 1377(b)(1)(A) of the Code and ending on the date on which the ETSC's AAA balance is zero. Additionally, an ETSC does not have an ETSC period if the ETSC's AAA balance is not greater than zero at the end of its post-termination transition period. See § 1.1371–2 for rules governing the impact of a post-termination period, within the meaning of section 1377(b)(1)(B), on the ETSC period.

(viii) *Excess qualified distribution*. The term *excess qualified distribution* means the portion of a qualified distribution that is not characterized pursuant to paragraph (b)(2) or (3) of this section.

(ix) *Historical AAA*. The term *historical AAA* means the AAA of the ETSC as of the beginning of the day on which the revocation of an election under section 1362(a) of the Code is effective pursuant to section 1362(d)(1).

(x) *Historical AE&P*. The term *historical AE&P* means the AE&P of the ETSC as of the beginning of the day on which the revocation of an election under section 1362(a) is effective pursuant to section 1362(d)(1). For purposes of the preceding sentence, if the ETSC's historical AE&P is less than zero, then the historical AE&P is treated as zero.

(xi) *Non-qualified distribution*. The term *non-qualified distribution* means a distribution that is not a qualified distribution and to which section 301 applies.

(xii) *Qualified distribution*. The term *qualified distribution* means a distribution of money by an ETSC during the ETSC period to which, absent the application of section 1371(f) and this section, section 301 would apply. However, if paragraph (d)(2)(i) of this section applies to the ETSC, then a qualified distribution to a non-legacy shareholder is treated as a non-qualified distribution.

(b) *Characterization of qualified distribution*—(1) *In general*. Paragraph (b)(2) of this section provides rules regarding the determination of the amount of a qualified distribution that is sourced from AAA and the corollary effects of such a characterization. Paragraph (b)(3) of this section provides rules regarding the determination of the amount of a qualified distribution that is sourced from AE&P and the corollary effects of such a characterization. Paragraph (b)(4) of this section provides rules regarding

the characterization of an excess qualified distribution as a separate qualified distribution. The rules in paragraphs (b)(2) through (4) of this section are applied before the application of paragraph (c) of this section.

(2) *Distribution of AAA*—(i) *Amount*. The portion of a qualified distribution that is sourced from an ETSC's AAA is equal to the lesser of:

(A) The product of the qualified distribution and the AAA ratio; and

(B) The ETSC's AAA immediately before the qualified distribution.

(ii) *Reduction or elimination of ETSC's AAA*. The ETSC's AAA is reduced by the amount of the distribution described in paragraph (b)(2)(i) of this section. If, with respect to a qualified distribution, the amount described in paragraph (b)(2)(i)(A) of this section equals or exceeds the amount described in paragraph (b)(2)(i)(B) of this section, then the rules in this paragraph (b) do not apply to any subsequent distributions by the ETSC. Instead, the subsequent distributions are treated in the manner provided in paragraph (c) of this section.

(iii) *Effect on the shareholder*. The amount described in paragraph (b)(2)(i) of this section is applied against and reduces the shareholder's adjusted basis of the shares of stock with respect to which the distribution is made under the principles of section 301(c)(2). If the application of the amount described in paragraph (b)(2)(i) of this section would result in a reduction of basis that exceeds the shareholder's adjusted basis of any share of stock with respect to which the distribution is made, such excess is treated as gain from the sale or exchange of property. The reduction of the shareholder's basis described in this paragraph with respect to a qualified distribution occurs prior to the application of paragraph (c) of this section to the excess qualified distribution, if any, with respect to such qualified distribution.

(3) *Distribution of AE&P*—(i) *Amount*. This paragraph (b)(3) applies if an ETSC's AE&P ratio is greater than zero. If this paragraph (b)(3) applies, the portion of a qualified distribution that is sourced from the ETSC's AE&P is equal to the lesser of:

(A) The product of the qualified distribution and the AE&P ratio; and

(B) The ETSC's AE&P immediately before the qualified distribution. For purposes of the preceding sentence, if the ETSC's AE&P immediately before the qualified distribution is less than zero, then the ETSC's AE&P is treated as zero.

(ii) *Effect on ETSC's AE&P*. The ETSC's AE&P is reduced, as described in section 312(a)(1), by the amount of the distribution described in paragraph (b)(3)(i) of this section. The AE&P reduction described in this paragraph occurs prior to the application of paragraph (c) of this section, even if a distribution to which paragraph (c) of this section applies (regarding excess qualified distributions and non-qualified distributions) occurs earlier in time than the qualified distribution to which this paragraph applies.

(iii) *Effect on the shareholder*. The amount of the qualified distribution that is sourced from the ETSC's AE&P described in paragraph (b)(3)(i) of this section is included in the gross income of the shareholder as a dividend under section 301(c)(1).

(iv) *Adjustment to the AAA ratio and the AE&P ratio*. After the application of paragraph (b)(3)(ii) of this section, if the ETSC's AE&P is zero and the ETSC's AAA is greater than zero, then the ETSC's AAA ratio is one and the ETSC's AE&P ratio is zero for all subsequent qualified distributions during:

(A) That taxable year; and

(B) All subsequent taxable years of the ETSC period.

(4) *Excess qualified distribution treated as a separate qualified distribution*—(i) *In general*. After the application of paragraph (b)(2)(ii) of this section with respect to a qualified distribution, if the ETSC has any remaining AAA, then any amount of excess qualified distribution, with respect to such qualified distribution, is treated as a separate qualified distribution and is analyzed pursuant to paragraph (b) of this section.

(ii) *No change in characterization of previously characterized portion of qualified distribution*. Paragraph (b)(4)(i) will not change the characterization of any portion of a qualified distribution that was previously characterized pursuant

to paragraphs (b)(2) and (3) of this section and will reflect the application of paragraphs (b)(2) and (3) of this section to the portion of the qualified distribution previously characterized.

(c) *Characterization of excess qualified distribution and non-qualified distributions.* After the application of paragraph (b), the excess qualified distributions, if any, and non-qualified distributions, if any, are treated in the manner provided in sections 301(c) and 316.

(d) *Examples.* Paragraphs (d)(1) through (5) of this section (*Examples 1* through *5*) illustrate the rules of this section. For purposes of paragraphs (d)(1) through (5) of this section (*Examples 1* through *5*), X is a calendar year S corporation with a single share of stock outstanding. A, an individual, purchased its share of X stock prior to December 22, 2017, and, except as otherwise indicated, never contributed any amounts to X's capital. A remained the sole shareholder of X when X made a valid revocation on March 15, 2018, pursuant to section 1362(d)(1) and §§ 1.1362–2 and 1.1362–6, of its S election and when that revocation became effective on January 1, 2018. X qualified as an ETSC pursuant to § 1.481–5(b) and its ETSC period began on January 1, 2019. Additionally, X did not make any distributions during its post-termination transition period, within the meaning of section 1377(b)(1)(A). Furthermore, A remains the sole shareholder of X at the time of the distribution(s) described.

(1) *Example 1: Historical AE&P is zero*—(i) *Facts.* At the beginning of January 1, 2018, X had AAA of $100 and AE&P of $0. During 2018, X had $300 of CE&P and made no distributions. At the beginning of January 1, 2019, X has AAA of $100 and AE&P of $300, and A's adjusted basis in its share of X stock is $460. During 2019, the only distribution that X makes is a $60 distribution of money to A on December 27. X's CE&P during 2019 is $150, without diminution by reason of any distributions made during the taxable year.

(ii) *Analysis*—(A) *Calculation of AAA ratio and AE&P ratio.* Pursuant to paragraphs (a)(2)(ix) and (x) of this section, respectively, X's historical AAA and X's historical AE&P are determined as of the beginning of January 1, 2018, the beginning of the day on which the revocation of X's election under section 1362(a) is effective pursuant to section 1362(d)(1). Accordingly, X's historical AAA is $100 and X's historical AE&P is $0. Therefore, X's AAA ratio is 1 ($100/($100 + $0)), and X's AE&P ratio is zero ($0/($100 + $0)).

(B) *Characterization of distribution.* Pursuant to paragraph (a)(2)(xii) of this section, the $60 distribution on December 27, 2019, is a qualified distribution because it is a distribution of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section.

(C) *Analysis of qualified distribution*—(*1*) *Distribution of AAA.* Pursuant to paragraph (b)(2)(i) of this section, the portion of the qualified distribution that is sourced from AAA is equal to the lesser of: The product of the qualified distribution and the AAA ratio ($60 × 1, or $60), and X's AAA immediately before the qualified distribution ($100). Therefore, $60 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $60 to $40. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $60 to $400.

(*2*) *Distribution of AE&P.* Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: The product of the qualified distribution and the AE&P ratio ($60 × 0, or $0), and X's AE&P immediately before the qualified distribution ($300). Therefore, $0 is sourced from AE&P.

(2) *Example 2: Qualified distributions with both historical AAA and historical AE&P*—(i) *Facts.* At the beginning of January 1, 2018, X had AAA of $200 and AE&P of $100. During 2018, X had $0 of CE&P and made no distributions. At the beginning of January 1, 2019, X has AAA of $200 and AE&P of $100, and A's adjusted basis in its share of X stock is $500. During 2019, X makes a $90 distribution of money on February 9 and a $150 distribution of money on June 5. X's CE&P during 2019 is $500, without diminution by reason of any distributions made during the taxable year.

(ii) *Analysis*—(A) *Calculation of AAA ratio and AE&P ratio*. Pursuant to paragraphs (a)(2)(ix) and (x) of this section, respectively, X's historical AAA and X's historical AE&P are determined as of the beginning of January 1, 2018, the beginning of the day on which the revocation of X's election under section 1362(a) is effective pursuant to section 1362(d)(1). Accordingly, X's historical AAA is $200 and X's historical AE&P is $100. Therefore, X's AAA ratio is 0.67 ($200/($200 + $100)), and X's AE&P ratio is 0.33 ($100/($200 + $100)).

(B) *Characterization of distributions*. Pursuant to paragraph (a)(2)(xii) of this section, the $90 distribution on February 9, 2019, and the $150 distribution on June 5, 2019, are both qualified distributions because they are distributions of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section.

(C) *Analysis of qualified distributions*—(*1*) *February 9, 2019 distribution*—(*i*) *Distribution of AAA*. Pursuant to paragraph (b)(2)(i) of this section, the portion of the qualified distribution that is sourced from AAA is equal to the lesser of: The product of the qualified distribution and the AAA ratio ($90 × 0.67, or $60), and X's AAA immediately before the qualified distribution ($200). Therefore, $60 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $60 to $140. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $60 to $440.

(*ii*) *Distribution of AE&P*. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the product of the qualified distribution and the AE&P ratio ($90 × 0.33, or $30), and X's AE&P immediately before the qualified distribution ($100). Therefore, $30 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $30 to $70. Pursuant to paragraph (b)(3)(iii) of this section, the $30 distribution is characterized as a dividend.

(*2*) *June 5, 2019 distribution*—(*i*) *Distribution of AAA*. Pursuant to paragraph (b)(2)(i) of this section, the portion of the qualified distribution that is sourced from AAA is equal to the lesser of: The product of the qualified distribution and the AAA ratio ($150 × 0.67, or $100), and X's AAA immediately before the qualified distribution ($140). Therefore, $100 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $100 to $40. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $100 to $340.

(*ii*) *Distribution of AE&P*. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: The product of the qualified distribution and the AE&P ratio ($150 × 0.33, or $50), and X's AE&P immediately before the qualified distribution ($70). Therefore, $50 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $50 to $20. Pursuant to paragraph (b)(3)(iii) of this section, the $50 distribution is characterized as a dividend.

(3) *Example 3: Limitation on amount characterized as AAA*—(i) *Facts*. At the beginning of January 1, 2018, X had AAA of $100 and AE&P of $300. During 2018, X had $280 of CE&P and made no distributions. At the beginning of January 1, 2019, X has AAA of $100 and AE&P of $580, and A's adjusted basis in its share of X stock is $450. During 2019, the only distribution that X makes is a $500 distribution of money to A on October 5. X's CE&P during 2019 is $150, without diminution by reason of any distributions made during the taxable year.

(ii) *Analysis*—(A) *Calculation of AAA ratio and AE&P ratio*. Pursuant to paragraphs (a)(2)(ix) and (x) of this section, respectively, X's historical AAA and X's historical AE&P are determined as of the beginning of January 1, 2018, the beginning of the day on which the revocation of X's election under section 1362(a) is effective pursuant to section 1362(d)(1). Accordingly, X's historical AAA is $100 and X's historical AE&P is $300. Therefore, X's AAA ratio is 0.25 ($100/($100 + $300)), and X's AE&P ratio is 0.75 ($300/($100 + $300)).

(B) *Characterization of distribution*. Pursuant to paragraph (a)(2)(xii) of this

section, the $500 distribution on October 5, 2019, is a qualified distribution because it is a distribution of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section.

(C) *Analysis of qualified distribution—(1) Distribution of AAA.* Pursuant to paragraph (b)(2)(i) of this section, the portion of the qualified distribution that is sourced from AAA is equal to the lesser of: The product of the qualified distribution and the AAA ratio ($500 × 0.25, or $125), and X's AAA immediately before the qualified distribution ($100). Therefore, $100 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $100 to $0. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $100 to $350.

(*2*) *Distribution of AE&P.* Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the product of the qualified distribution and the AE&P ratio ($500 × 0.75, or $375), and X's AE&P immediately before the qualified distribution ($580). Therefore, $375 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $375 to $205. Pursuant to paragraph (b)(3)(iii) of this section, the $375 distribution is characterized as a dividend.

(D) *Effect of qualified distribution on ETSC period.* Pursuant to paragraph (a)(2)(vii) of this section, X's ETSC period ends because X's AAA balance is zero following the October 5, 2019 distribution.

(E) *Analysis of excess qualified distribution—(1) Amount of excess qualified distribution.* Pursuant to paragraph (a)(2)(viii) of this section, the amount of the excess qualified distribution is $25, the portion of the qualified distribution ($500) not characterized pursuant to paragraph (b)(2) or (3) of this section ($100 AAA distribution + $375 AE&P distribution).

(*2*) *Characterization of excess qualified distribution.* Paragraph (b)(4) of this section does not apply to the excess qualified distribution because X's AAA balance is zero after the application of paragraph (b)(2)(ii) of this section (see paragraph (d)(3)(ii)(C)(*1*) of this section). Pursuant to paragraph (c) of this section, section 301(c) applies to the excess qualified distribution. Pursuant to sections 301(c)(1) and 316, the $25 excess qualified distribution is sourced from CE&P.

(iii) *Subsequent contribution.* The facts are the same as paragraph (d)(3)(i) of this section, except that at the time of the October 5, 2019 distribution, A's adjusted basis in its X stock is $90. Further, on December 27, 2019, A contributes $100 to X in a transaction described in section 351(a). The analysis in paragraph (d)(3)(ii) of this section remains the same, except that, unlike the second to last sentence of paragraph (d)(3)(ii)(C)(*1*) of this section, A's basis in its X stock is reduced by $90 to $0 and pursuant to paragraph (b)(2)(iii) of this section, $10 is treated as gain from the sale or exchange of property. Additionally, as a result of the December 27, 2019 contribution of $100, A's basis in its X stock is increased by $100, so that at the end of 2019, A's basis in its X stock is $100.

(4) *Example 4: Limitation on the amount characterized as AE&P*—(i) *Facts.* At the beginning of January 1, 2018, X had AAA of $100 and AE&P of $100. During 2018, X had CE&P of $(75) and made no distributions. At the beginning of January 1, 2019, X has AAA of $100 and AE&P of $25, and A's adjusted basis in its share of X stock is $500. During 2019, the only distributions that X makes are a $100 distribution of money to A on July 9 and a $40 distribution of money to A on September 27. X's CE&P during 2019 is $20, without diminution by reason of any distributions made during the taxable year.

(ii) *Analysis*—(A) *Calculation of AAA ratio and AE&P ratio.* Pursuant to paragraphs (a)(2)(ix) and (x) of this section, respectively, X's historical AAA and X's historical AE&P are determined as of the beginning of January 1, 2018, the beginning of the day on which the revocation of X's election under section 1362(a) is effective pursuant to section 1362(d)(1). Accordingly, X's historical AAA is $100 and X's historical AE&P is $100. Therefore, X's AAA ratio is 0.5

($100/($100 + $100)), and X's AE&P ratio is 0.5 ($100/($100 + $100)).

(B) *Analysis of July 9, 2019 distribution—(1) Characterization of distribution.* Pursuant to paragraph (a)(2)(xii) of this section, the $100 distribution on July 9, 2019, is a qualified distribution because it is a distribution of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section.

(*2*) *Analysis of qualified distribution—*(*i*) *Distribution of AAA.* Pursuant to paragraph (b)(2)(i) of this section, the portion of the distribution that is sourced from AAA is equal to the lesser of: The product of the qualified distribution and the AAA ratio ($100 × 0.5, or $50), and X's AAA immediately before the qualified distribution ($100). Therefore, $50 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $50 to $50. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $50 to $450.

(*ii*) *Distribution of AE&P.* Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: The product of the qualified distribution and the AE&P ratio ($100 × 0.5, or $50), and X's AE&P immediately before the qualified distribution ($25). Therefore, $25 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $25 to $0. Pursuant to paragraph (b)(3)(iii) of this section, $25 of the distribution is characterized as a dividend.

(*3*) *Recalculation of AAA and AE&P ratios.* Pursuant to paragraph (b)(3)(iv) of this section, because the July 9, 2019 distribution caused X's AE&P to be reduced to zero, the AAA ratio is one and the AE&P ratio is zero for all subsequent qualified distributions during the 2019 taxable year and subsequent taxable years of the ETSC period.

(*4*) *Excess qualified distribution—*(*i*) *Amount of excess qualified distribution.* Pursuant to paragraph (a)(2)(viii) of this section, the amount of the excess qualified distribution is $25, the amount of the qualified distribution ($100) not characterized pursuant to paragraph (b)(2) or (3) of this section ($50 AAA distribution + $25 AE&P distribution).

(*ii*) *Characterization of excess qualified distribution as a separate qualified distribution.* Pursuant to paragraph (b)(4) of this section, because X has AAA remaining after characterizing the qualified distribution (*see* paragraph (d)(4)(ii)(B)(*2*)(*i*) of this section), the $25 excess qualified distribution is treated as a separate qualified distribution and is analyzed pursuant to paragraph (b) of this section.

(iii) *Analysis of excess qualified distribution that is treated as a separate qualified distribution.* Pursuant to paragraph (b)(2)(i) of this section, the portion of the distribution that is sourced from AAA is equal to the lesser of: The product of the excess qualified distribution and the AAA ratio ($25 × 1, or $25), and X's AAA immediately before the excess qualified distribution ($50). Therefore, $25 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $25 to $25. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $25 to $425. Pursuant to paragraph (b)(3)(i) of this section, because X's AE&P ratio is zero, paragraph (b)(3) of this section does not apply.

(C) *Analysis of September 27, 2019 distribution—(1) Characterization of the distribution.* Pursuant to paragraph (a)(2)(xii) of this section, the $40 distribution on September 27, 2019, is a qualified distribution because it is a distribution of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section.

(*2*) *Analysis of qualified distribution—*(*i*) *Distribution of AAA.* Pursuant to paragraph (b)(2)(i) of this section, the portion of the distribution that is sourced from AAA is equal to the lesser of: The product of the qualified distribution and the AAA ratio ($40 × 1, or $40), and X's AAA immediately before the qualified distribution ($25) (*see* paragraph (d)(4)(ii)(B)(*4*)(*iii*) of this section). Therefore, $25 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution,

X's AAA is reduced by $25 to $0. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $25 to $400.

(*ii*) *Distribution of AE&P*. Pursuant to paragraph (b)(3)(i) of this section, because X's AE&P ratio is zero, paragraph (b)(3) of this section does not apply.

(*3*) *Excess qualified distribution*—(*i*) *Amount of excess qualified distribution*. Pursuant to paragraph (a)(2)(viii) of this section, the amount of the excess qualified distribution is $15, the portion of the qualified distribution ($40) not characterized pursuant to paragraph (b)(2) or (3) of this section ($25 AAA distribution + $0 AE&P distribution).

(*ii*) *Excess qualified distribution not characterized as a separate qualified distribution*. Pursuant to paragraph (b)(4) of this section, because X has AAA of $0 after characterizing the qualified distribution (*see* paragraph (d)(4)(ii)(C)(*2*)(*i*) of this section), the $15 excess qualified distribution is not treated as a separate qualified distribution.

(iii) *Analysis of excess qualified distribution that is not treated as a separate qualified distribution*. Pursuant to paragraph (c) of this section, section 301(c) applies to the excess qualified distribution. Pursuant to sections 301(c)(1) and 316, the $15 excess qualified distribution is sourced from CE&P.

(5) *Example 5: Distributions include non-qualified distributions*—(i) *Facts*. At the beginning of January 1, 2018, X had AAA of $100 and AE&P of $100. During 2018, X had $0 of CE&P and made no distributions. At the beginning of January 1, 2019, X has AAA of $100 and AE&P of $100, and A's adjusted basis in its X stock is $200. During 2019, X makes a $100 distribution of money on June 14; a $300 distribution of property on November 9; and a $200 distribution of money on December 18. X's CE&P during 2019 is $160, without diminution by reason of any distributions made during the taxable year.

(ii) *Analysis*—(A) *Calculation of AAA ratio and AE&P ratio*. Pursuant to paragraphs (a)(2)(ix) and (x) of this section, respectively, X's historical AAA is $100 and X's historical AE&P is $100. Therefore, X's AAA ratio is 0.5 ($100/($100 + $100)), and X's AE&P ratio is 0.5 ($100/($100 + $100)).

(B) *Characterization of distributions*. Pursuant to paragraph (a)(2)(xii) of this section, the $100 distribution on June 14, 2019, and the $200 distribution on December 18, 2019, are both qualified distributions because they are distributions of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section. Pursuant to paragraph (a)(2)(xi) of this section, the $300 distribution of property on November 9, 2019, is a non-qualified distribution. Pursuant to paragraph (b)(1) of this section, the rules of paragraph (b)(2) through (b)(4) of this section apply to the qualified distributions before the rules of paragraph (c) of this section apply to the non-qualified distribution and any excess qualified distributions.

(C) *Analysis of qualified distributions*—(*1*) *June 14, 2019 distribution*—(*i*) *Distribution of AAA*. Pursuant to paragraph (b)(2)(i) of this section, the portion of the distribution that is sourced from AAA is equal to the lesser of: The product of the qualified distribution and the AAA ratio ($100 × 0.5, or $50), and X's AAA immediately before the qualified distribution ($100). Therefore, $50 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $50 to $50. Pursuant to paragraph (b)(2)(iii) of this section, on June 14, 2019, A's basis in its X stock is reduced by $50 to $150.

(*ii*) *Distribution of AE&P*. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: The product of the qualified distribution and the AE&P ratio ($100 × 0.5, or $50), and X's AE&P immediately before the qualified distribution ($100). Therefore, $50 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $50 to $50. Pursuant to paragraph (b)(3)(iii) of this section, the $50 distribution is characterized as a dividend.

(*iii*) *Amount of excess qualified distribution*. The amount of the excess qualified distribution is $0, the amount of the qualified distribution ($100) not

characterized pursuant to paragraph (b)(2) or (3) of this section ($50 AAA distribution + $50 AE&P distribution).

(*2*) *December 18, 2019 distribution*—(*i*) *Distribution of AAA*. Pursuant to paragraph (b)(2)(i) of this section, the portion of the distribution that is sourced from AAA is equal to the lesser of: The product of the qualified distribution and the AAA ratio ($200 × 0.5, or $100), and X's AAA immediately before the qualified distribution ($50). Therefore, $50 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $50 to $0. Pursuant to paragraph (b)(2)(iii) of this section, A must determine its basis as of December 18, 2019, in order to determine the consequences of receiving the $50 AAA distribution. Because the non-qualified distribution on November 9, 2019, which precedes the December 18, 2019 qualified distribution, could have the effect of reducing A's basis, any effect on A's basis from that non-qualified distribution must be analyzed prior to determining the effect of the December 18, 2019 distribution of AAA on A's basis. See paragraphs (d)(5)(ii)(D)(*3*) and (*4*) of this section. Pursuant to paragraph (a)(2)(vii) of this section, X's ETSC period ends because X's AAA balance is zero following the December 18, 2019 distribution.

(*ii*) *Distribution of AE&P*. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: The product of the qualified distribution and the AE&P ratio ($200 × 0.5, or $100), and X's AE&P immediately before the qualified distribution ($50). Therefore, $50 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $50 to $0. Pursuant to paragraph (b)(3)(iii) of this section, the $50 distribution is characterized as a dividend.

(*iii*) *Amount of excess qualified distribution*. The amount of the excess qualified distribution is $100, the amount of the qualified distribution ($200) not characterized pursuant to paragraph (b)(2) or (3) of this section ($50 AAA distribution + $50 AE&P distribution).

(D) *Analysis of non-qualified and excess qualified distributions*—(*1*) *In general*. The $300 non-qualified distribution on November 9, 2019, and the $100 excess qualified distribution on December 18, 2019, are treated in the manner provided in section 301(c).

(*2*) *Allocation of CE&P*. Pursuant to section 316 and § 1.316–2, X's CE&P is allocated proportionately among the excess qualified and the non-qualified distributions. Therefore, the portion of X's CE&P that is allocated to the November 9, 2019 distribution and the December 18, 2019 distribution is $120 ($160 CE&P × ($300 distribution/$400 total excess qualified and non-qualified distributions during 2019) and $40 ($160 CE&P × ($100 distribution/$400 total excess qualified and non-qualified distributions during 2019), respectively.

(*3*) *November 9, 2019 distribution*. Pursuant to paragraph (d)(5)(ii)(D)(*2*) of this section, $120 of the $300 distribution is characterized as a distribution of CE&P. Pursuant to paragraph (d)(5)(ii)(C)(*2*)(*ii*) of this section, the amount of X's AE&P available to allocate the November 9, 2019 distribution is $0. Therefore, the remaining $180 is characterized pursuant to section 301(c)(2) and (3). Pursuant to paragraph (d)(5)(ii)(C)(*1*)(*i*) of this section, A's basis in its X stock prior to the November 9, 2019 distribution is $150. Therefore, $150 is applied against basis pursuant to section 301(c)(2) (reducing A's basis to $0) and $30 is treated as gain from the sale or exchange of property pursuant to section 301(c)(3).

(*4*) *December 18, 2019 distribution*—(*i*) *Consequences of AAA distribution*. As of December 18, 2019, A's basis in its X stock is $0. See paragraph (d)(5)(ii)(D)(*3*) of this section. Pursuant to paragraph (d)(5)(ii)(C)(*2*)(*i*) of this section, $50 of the distribution is characterized as a distribution of AAA. Because the amount of the distribution of AAA ($50) exceeds A's basis in its X stock ($0), pursuant to paragraph (b)(2)(iii) of this section, on December 18, 2019, $50 is treated as gain from the sale or exchange of property.

(*ii*) *Characterization of excess qualified distribution*. Pursuant to paragraph (d)(5)(ii)(C)(*2*)(*iii*) of this section, $100 of the December 18, 2019 distribution is an excess qualified distribution. Paragraph (b)(4) of this section does not

apply to the excess qualified distribution because X's AAA balance is zero after the application of paragraph (b)(2)(ii) of this section (see paragraph (d)(5)(ii)(C)(*2*)(*i*) of this section. Pursuant to paragraph (c) of this section, section 301(c) applies to the excess qualified distribution. Pursuant to paragraph (d)(5)(ii)(D)(*2*) of this section, $40 of the $100 excess qualified distribution is characterized as a distribution of CE&P. Pursuant to paragraph (d)(5)(ii)(D)(*3*) of this section, X's AE&P as the time of the December 18, 2019 distribution is $0. Therefore, the remaining $60 is characterized pursuant to section 301(c)(2) and (3). Pursuant to paragraph (d)(5)(ii)(D)(*4*)(*i*) of this section, A's basis in its X stock prior to characterization of the excess qualified distribution is $0. Therefore, $60 is treated as gain from the sale or exchange of property pursuant to section 301(c)(3).

(e) *Applicability date*. This section applies to taxable years beginning after October 20, 2020. However, a corporation may choose to apply the rules in §§ 1.481–5, 1.1371–1, and 1.1371–2 in their entirety to taxable years beginning on or before October 20, 2020. If a corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently, and the corporation must continue to apply the rules in §§ 1.481–5, 1.1371–1, and 1.1371–2 in their entirety for the corporation's subsequent taxable years.

[T.D. 9914, 85 FR 66478, Oct. 20, 2020]

§ 1.1371–2 Impact of Audit PTTP on ETSC Period.

(a) *Definitions*. For purposes of this section, the definitions used in § 1.1371–1(a)(2) are applicable. Additionally, the following definitions apply for purposes of this section—

(1) *Audit PTTP*. The term *audit PTTP* means a post-termination transition period described in section 1377(b)(1)(B) of the Internal Revenue Code (Code).

(2) *Initial PTTP*. The term *initial PTTP* means a post-termination transition period described in section 1377(b)(1)(A).

(3) *Intervening audit PTTP*. The term *intervening audit PTTP* means an audit PTTP arising during the ETSC period.

(b) *In general*. If an intervening audit PTTP arises, the ETSC period immediately stops. Immediately following the end of the intervening audit PTTP, the ETSC period resumes if the ETSC's AAA balance is greater than zero. Otherwise, any subsequent distributions by the ETSC are treated in the manner provided in section 301(c) of the Code.

(c) *Examples*. Paragraphs (c)(1) and (2) of this section (*Examples 1* and *2*) illustrate the rules of this section. For purposes of paragraphs (c)(1) and (2) of this section (*Examples 1* and *2*), X is a calendar year S corporation. A, an individual, purchased all of the outstanding shares of X in a single transaction at the same price per share prior to December 22, 2017, and was the sole shareholder of X at all times. Pursuant to section 1362(d)(1) of the Code and §§ 1.1362–2 and 1.1362–6, X made a valid revocation of its S election on March 15, 2019, that became effective on January 1, 2019. No amount distributed by X is an extraordinary dividend within the meaning of section 1059.

(1) *Example 1: No ETSC period following initial PTTP*—(i) *Facts*. At the beginning of January 1, 2019, X had AAA of $49,000 and AE&P of $2,000, and A's adjusted basis in its shares of X stock was $50,000. During 2019, the only distribution that X made was a $49,000 distribution of money to A on March 13, 2019. X's CE&P during 2019 was $0, without regard to any diminution by reason of any distributions made during the taxable year.

(ii) *Analysis*—(A) *Distribution during initial PTTP*. Pursuant to sections 1371(e) and 1377(b)(1)(A), the $49,000 distribution of money on March 13, 2019, is characterized as a distribution of AAA because it was made during the initial PTTP.

(B) *Effect on corporation*. Pursuant to § 1.1368–2(a)(3)(iii), X's AAA is reduced by $49,000 to $0. Following the initial PTTP, even if X satisfies the requirements of section 481(d)(2) of the Code and § 1.481–5(b) to be an ETSC, X does not have an ETSC period because its AAA balance is zero at the end of its initial PTTP. Therefore, section 1371(f) of the Code and § 1.1371–1 will not apply to any subsequent distributions by X.

(C) *Effect on shareholder*. Pursuant to section 1371(e)(1), A reduces its basis in its X stock by $49,000 to $1,000.

(2) *Example 2: Intervening audit PTTP*—(i) *Facts*. The facts are the same as the facts in paragraph (c)(1) of this section. On May 20, 2020, which is after X's initial PTTP, the IRS begins an audit of X's 2018 return. During the audit it is agreed that X overstated its advertising expense deduction by $10,000. On July 6, 2020, A signs a closing agreement whereby X's overstatement results in an additional tax on A's 2018 individual return. As a result, at the beginning of January 1, 2019, X had AAA of $59,000 ($49,000 + $10,000) and AE&P of $2,000. Additionally, at the beginning of January 1, 2019, A's adjusted basis in its shares of X stock was $60,000 ($50,000 + $10,000). During 2020, the only distribution X makes is a $6,000 distribution of money to A on September 1, 2020. X's CE&P during 2020 was $0, without regard to any diminution by reason of any distributions made during the taxable year.

(ii) *Analysis*—(A) *Analysis of March 13, 2019 distribution*. The treatment of the March 13, 2019, distribution is the same as described in paragraph (c)(1)(ii)(A) of this section, because the amount of the distribution ($49,000) does not exceed X's AAA balance at the beginning of January 1, 2019 ($59,000), and so the entirety of the $49,000 distribution is properly characterized as a distribution of AAA.

(*1*) *Effect on corporation*. As described in paragraph (c)(1)(ii)(B) of this section, X's AAA ($59,000 at the beginning of January 1, 2019) is reduced by $49,000 to $10,000. At the conclusion of X's initial PTTP (ending on December 31, 2019), X's AAA balance is $10,000. Pursuant to §1.1371–1(a)(2)(vii), X has an ETSC period. Therefore, section 1371(f) and §1.1371–1 will apply to any subsequent qualified distributions by X.

(*2*) *Effect on shareholder*. As described in paragraph (c)(1)(ii)(C) of this section, A reduces its basis in its X stock ($60,000 at the beginning of January 1, 2019) by $49,000 to $11,000.

(B) *Intervening audit PTTP*. Pursuant to section 1377(b)(1)(B), X enters an intervening audit PTTP that begins on July 6, 2020, and ends on November 2, 2020. The application of section 1371(f) and §1.1371–1 to distributions during the intervening audit PTTP is stopped. Instead, sections 1371(e) and 1377(b)(1)(B) and §§1.1371–2 and 1.1377–2 apply for the duration of the intervening audit PTTP. During the intervening audit PTTP, the only distribution X made is a $6,000 distribution of money to A on September 1, 2020. Pursuant to sections 1371(e) and 1377(b)(1)(B), the $6,000 distribution is characterized as a distribution of AAA because it was made during the intervening audit PTTP.

(*1*) *Effect on corporation*. Pursuant to §1.1368–2(a)(3)(iii), X's AAA is reduced by $6,000 to $4,000. Beginning on November 3, 2020, pursuant to §1.1371–1(a)(2)(vii), X's ETSC period resumes (after the intervening audit PTTP's conclusion) because its AAA balance is greater than zero.

(*2*) *Effect on shareholder*. Pursuant to section 1371(e)(1), A reduces its basis in its X stock by $6,000 to $5,000.

(C) *ETSC period*. Beginning on November 3, 2020, X's ETSC period resumes, and distributions of money are subject to section 1371(f) and §1.1371–1 until X's AAA balance is zero. For purposes of calculating each of X's AAA and AE&P ratios, X's historical AAA is $59,000 (at the beginning of January 1, 2019, which includes the $10,000 increase as a result of the July 6, 2020, closing agreement).

(d) *Applicability date*. This section applies to taxable years beginning after October 20, 2020. However, a corporation may choose to apply the rules in §§1.481–5, 1.1371–1, and 1.1371–2 in their entirety to taxable years that began on or before October 20, 2020. If a corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently, and the corporation must continue to apply the rules in §§1.481–5, 1.1371–1, and 1.1371–2 in their entirety for the corporation's subsequent taxable years.

[T.D. 9914, 85 FR 66478, Oct. 20, 2020]

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[T.D. 8579, 59 FR 66463, Dec. 27, 1994, as amended by T.D. 9236, 70 FR 75731, Dec. 21, 2005]

§ 1.1374–1 General rules and definitions.

(a) *Computation of tax.* The tax imposed on the income of an S corporation by section 1374(a) for any taxable year during the recognition period is computed as follows—

(1) Step One: Determine the net recognized built-in gain of the corporation for the taxable year under section 1374(d)(2) and § 1.1374–2;

(2) Step Two: Reduce the net recognized built-in gain (but not below zero) by any net operating loss and capital loss carryforward allowed under section 1374(b)(2) and § 1.1374–5;

(3) Step Three: Compute a tentative tax by applying the rate of tax determined under section 1374(b)(1) for the taxable year to the amount determined under paragraph (a)(2) of this section;

(4) Step Four: Compute the final tax by reducing the tentative tax (but not below zero) by any credit allowed under section 1374(b)(3) and § 1.1374–6.

(b) *Anti-trafficking rules.* If section 382, 383, or 384 would have applied to limit the use of a corporation's recognized built-in loss or section 1374 attributes at the beginning of the first day of the recognition period if the corporation had remained a C corporation, these sections apply to limit their use in determining the S corporation's pre-limitation amount, taxable income limitation, net unrealized built-in gain limitation, deductions against net recognized built-in gain, and credits against the section 1374 tax.

(c) *Section 1374 attributes.* Section 1374 attributes are the loss carryforwards allowed under section 1374(b)(2) as a deduction against net recognized built-in gain and the credit and credit carryforwards allowed under section 1374(b)(3) as a credit against the section 1374 tax.

(d) *Recognition period.* The recognition period is the 10-year (120-month) period beginning on the first day the corporation is an S corporation or the day an S corporation acquires assets in a section 1374(d)(8) transaction. For example, if the first day of the recognition period is July 14, 1996, the last day of the recognition period is July 13, 2006. If the recognition period for certain assets ends during an S corporation's taxable year (for example, because the corporation was on a fiscal year as a C corporation and changed to a calendar year as an S corporation or because an S corporation acquired assets in a section 1374(d)(8) transaction during a taxable year), the S corporation must determine its pre-limitation amount (as defined in §1.1374–2(a)(1)) for the year as if the corporation's books were closed at the end of the recognition period.

(e) *Predecessor corporation.* For purposes of section 1374(c)(1), if the basis of an asset of the S corporation is determined (in whole or in part) by reference to the basis of the asset (or any other property) in the hands of another corporation, the other corporation is a predecessor corporation of the S corporation.

[T.D. 8579, 59 FR 66463, Dec. 27, 1994]

§1.1374–2 Net recognized built-in gain.

(a) *In general.* An S corporation's net recognized built-in gain for any taxable year is the least of—

(1) Its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover (pre-limitation amount);

(2) Its taxable income determined by using all rules applying to C corporations as modified by section 1375(b)(1)(B) (taxable income limitation); and

(3) The amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior taxable years (net unrealized built-in gain limitation).

(b) *Allocation rule.* If an S corporation's pre-limitation amount for any taxable year exceeds its net recognized built-in gain for that year, the S corporation's net recognized built-in gain consists of a ratable portion of each item of income, gain, loss, and deduction included in the pre-limitation amount.

(c) *Recognized built-in gain carryover.* If an S corporation's net recognized built-in gain for any taxable year is equal to its taxable income limitation, the amount by which its pre-limitation amount exceeds its taxable income limitation is a recognized built-in gain carryover included in its pre-limitation amount for the succeeding taxable year. The recognized built-in gain carryover consists of that portion of each item of income, gain, loss, and deduction not included in the S corporation's net recognized built-in gain for the year the carryover arose, as determined under paragraph (b) of this section.

(d) *Accounting methods.* In determining its taxable income for pre-limitation amount and taxable income limitation purposes, a corporation must use the accounting method(s) it uses for tax purposes as an S corporation.

(e) *Example.* The rules of this section are illustrated by the following example.

Example: Net recognized built-in gain. X is a calendar year C corporation that elects to become an S corporation on January 1, 1996. X has a net unrealized built-in gain of $50,000

and no net operating loss or capital loss carryforwards. In 1996, X has a pre-limitation amount of $20,000, consisting of ordinary income of $15,000 and capital gain of $5,000, a taxable income limitation of $9,600, and a net unrealized built-in gain limitation of $50,000. Therefore, X's net recognized built-in gain for 1996 is $9,600, because that is the least of the three amounts described in paragraph (a) of this section. Under paragraph (b) of this section, X's net recognized built-in gain consists of recognized built-in ordinary income of $7,200 [$15,000 × ($9,600/$20,000) = $7,200] and recognized built-in capital gain of $2,400 [$5,000 × ($9,600/$20,000) = $2,400]. Under paragraph (c) of this section, X has a recognized built-in gain carryover to 1997 of $10,400 ($20,000 − $9,600 = $10,400), consisting of $7,800 ($15,000 − $7,200 = $7,800) of recognized built-in ordinary income and $2,600 ($5,000 − $2,400 = $2,600) of recognized built-in capital gain.

[T.D. 8579, 59 FR 66463, Dec. 27, 1994]

§ 1.1374–3 Net unrealized built-in gain.

(a) *In general.* An S corporation's net unrealized built-in gain is the total of the following—

(1) The amount that would be the amount realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold all its assets at fair market value to an unrelated party that assumed all its liabilities; decreased by

(2) Any liability of the corporation that would be included in the amount realized on the sale referred to in paragraph (a)(1) of this section, but only if the corporation would be allowed a deduction on payment of the liability; decreased by

(3) The aggregate adjusted bases of the corporation's assets at the time of the sale referred to in paragraph (a)(1) of this section; increased or decreased by

(4) The corporation's section 481 adjustments that would be taken into account on the sale referred to in paragraph (a)(1) of this section; and increased by

(5) Any recognized built-in loss that would not be allowed as a deduction under section 382, 383, or 384 on the sale referred to in paragraph (a)(1) of this section.

(b) *Adjustment to net unrealized built-in gain*—(1) *In general.* If section 1374(d)(8) applies to an S corporation's acquisition of assets, some or all of the stock of the corporation from which such assets were acquired was taken into account in the computation of the net unrealized built-in gain for a pool of assets of the S corporation, and some or all of such stock is redeemed or canceled in such transaction, then, subject to the limitations of paragraph (b)(2) of this section, such net unrealized built-in gain is adjusted to eliminate any effect that any built-in gain or built-in loss in the redeemed or canceled stock (other than stock with respect to which a loss under section 165 is claimed) had on the initial computation of net unrealized built-in gain for that pool of assets. For purposes of this paragraph, stock described in section 1374(d)(6) shall be treated as taken into account in the computation of the net unrealized built-in gain for a pool of assets of the S corporation.

(2) *Limitations on adjustment*—(i) *Recognized built-in gain or loss.* Net unrealized built-in gain for a pool of assets of the S corporation is only adjusted under paragraph (b)(1) of this section to reflect built-in gain or built-in loss in the redeemed or canceled stock that has not resulted in recognized built-in gain or recognized built-in loss during the recognition period.

(ii) *Anti-duplication rule.* Paragraph (b)(1) of this section shall not be applied to duplicate an adjustment to the net unrealized built-in gain for a pool of assets made pursuant to paragraph (b)(1) of this section.

(3) *Effect of adjustment.* Any adjustment to the net unrealized built-in gain made pursuant to this paragraph (b) only affects computations of the amount subject to tax under section 1374 for taxable years that end on or after the date of the acquisition to which section 1374(d)(8) applies.

(4) *Pool of assets.* For purposes of this section, a pool of assets means—

(i) The assets held by the corporation on the first day it became an S corporation, if the corporation was previously a C corporation; or

(ii) The assets the S corporation acquired from a C corporation in a section 1374(d)(8) transaction.

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

Example 1. Computation of net unrealized built-in gain. (i)(A) X, a calendar year C corporation using the cash method, elects to become an S corporation on January 1, 1996. On December 31, 1995, X has assets and liabilities as follows:

Assets	FMV	Basis
Factory	$500,000	$900,000
Accounts Receivable	300,000	0
Goodwill	250,000	0
Total	1,050,000	900,000

Liabilities	Amount
Mortgage	$200,000
Accounts Payable	100,000
Total	300,000

(B) Further, X must include a total of $60,000 in taxable income in 1996, 1997, and 1998 under section 481(a).

(ii) If, on December 31, 1995, X sold all its assets to a third party that assumed all its liabilities, X's amount realized would be $1,050,000 ($750,000 cash received + $300,000 liabilities assumed = $1,050,000). Thus, X's net unrealized built-in gain is determined as follows:

Amount realized	$1,050,000
Deduction allowed (A/P)	(100,000)
Basis of X's assets	(900,000)
Section 481 adjustments	60,000
Net unrealized built-in gain	110,000

Example 2. Adjustment to net unrealized built-in gain for built-in gain in eliminated C corporation stock. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of $15,000. Among the assets in the first pool of assets is all of the outstanding stock of Y, a C corporation, with a fair market value of $33,000 and an adjusted basis of $18,000. On March 1, 2009, X sells an asset that it owned on January 1, 2005, and as a result has $10,000 of recognized built-in gain. X has had no other recognized built-in gain or built-in loss. X's taxable income limitation for 2009 is $50,000. Effective June 1, 2009, X elects under section 1361 to treat Y as a qualified subchapter S subsidiary (QSub). The election is treated as a transfer of Y's assets to X in a liquidation to which sections 332 and 337(a) apply.

(ii) Under paragraph (b) of this section, the net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the liquidation. The net unrealized built-in gain of the first pool of assets, therefore, is decreased by $15,000, the amount by which the fair market value of the Y stock exceeded its adjusted basis as of January 1, 2005. Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is $0.

(iii) Under §1.1374–2(a), X's net recognized built-in gain for any taxable year equals the least of X's pre-limitation amount, taxable income limitation, and net unrealized built-in gain limitation. In 2009, X's pre-limitation amount is $10,000, X's taxable income limitation is $50,000, and X's net unrealized built-in gain limitation is $0. Because the net unrealized built-in gain of the first pool of assets has been adjusted to $0, despite the $10,000 of recognized built-in gain in 2009, X has $0 net recognized built-in gain for the taxable year ending on December 31, 2009.

Example 3. Adjustment to net unrealized built-in gain for built-in loss in eliminated C corporation stock. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of negative $5,000. Among the assets in the first pool of assets is 10 percent of the outstanding stock of Y, a C corporation, with a fair market value of $18,000 and an adjusted basis of $33,000. On March 1, 2009, X sells an asset that it owned on January 1, 2005, resulting in $8,000 of recognized built-in gain. X has had no other recognized built-in gains or built-in losses. X's taxable income limitation for 2009 is $50,000. On June 1, 2009, Y transfers its assets to X in a reorganization under section 368(a)(1)(C).

(ii) Under paragraph (b) of this section, the net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the reorganization. The net unrealized built-in gain of the first pool of assets, therefore, is increased by $15,000, the amount by which the adjusted basis of the Y stock exceeded its fair market value as of January 1, 2005. Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is $10,000.

(iii) Under §1.1374–2(a), X's net recognized built-in gain for any taxable year equals the least of X's pre-limitation amount, taxable income limitation, and net unrealized built-in gain limitation. In 2009, X's pre-limitation amount is $8,000 and X's taxable income limitation is $50,000. The net unrealized built-in gain of the first pool of assets has been adjusted to $10,000, so X's net unrealized built-in gain limitation is $10,000. X, therefore, has $8,000 net recognized built-in gain for the taxable year ending on December 31, 2009. X's net unrealized built-in gain limitation for 2010 is $2,000.

Example 4. Adjustment to net unrealized built-in gain in case of prior gain recognition. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of $30,000. Among the assets in the first pool

of assets is all of the outstanding stock of Y, a C corporation, with a fair market value of $45,000 and an adjusted basis of $10,000. Y has no current or accumulated earnings and profits. On April 1, 2007, Y distributes $18,000 to X, $8,000 of which is treated as gain to X from the sale or exchange of property under section 301(c)(3). That $8,000 is recognized built-in gain to X under section 1374(d)(3), and results in $8,000 of net recognized built-in gain to X for 2007. X's net unrealized built-in gain limitation for 2008 is $22,000. On June 1, 2009, Y transfers its assets to X in a liquidation to which sections 332 and 337(a) apply.

(ii) Under paragraph (b) of this section, the net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the liquidation. The net unrealized built-in gain of that pool of assets, however, can only be adjusted to reflect the amount of built-in gain that was inherent in the Y stock on January 1, 2005 that has not resulted in recognized built-in gain during the recognition period. In this case, therefore, the net unrealized built-in gain of the first pool of assets cannot be reduced by more than $27,000 ($35,000, the amount by which the fair market value of the Y stock exceeded its adjusted basis as of January 1, 2005, minus $8,000, the recognized built-in gain with respect to the stock during the recognition period). Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is $3,000. The net unrealized built-in gain limitation for 2009 is $0.

[T.D. 8579, 59 FR 66464, Dec. 27, 1994, as amended by T.D. 9180, 70 FR 8728, Feb. 23, 2005]

§ 1.1374–4 Recognized built-in gain or loss.

(a) *Sales and exchanges*—(1) *In general.* Section 1374(d)(3) or 1374(d)(4) applies to any gain or loss recognized during the recognition period in a transaction treated as a sale or exchange for Federal income tax purposes.

(2) *Oil and gas property.* For purposes of paragraph (a)(1) of this section, an S corporation's adjusted basis in oil and gas property equals the sum of the shareholders' adjusted bases in the property as determined in section 613A(c)(11)(B).

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

Example 1. Production and sale of oil. X is a C corporation that purchased a working interest in an oil and gas property for $100,000 on July 1, 1993. X elects to become an S corporation effective January 1, 1996. On that date, the working interest has a fair market value of $250,000 and an adjusted basis of $50,000, but no oil has as yet been extracted. In 1996, X begins production of the working interest, sells oil that it has produced to a refinery for $75,000, and includes that amount in gross income. Under paragraph (a)(1) of this section, the $75,000 is not recognized built-in gain because as of the beginning of the recognition period X held only a working interest in the oil and gas property (since the oil had not yet been extracted from the ground), and not the oil itself.

Example 2. Sale of oil and gas property. Y is a C corporation that elects to become an S corporation effective January 1, 1996. Y has two shareholders, A and B. A and B each own 50 percent of Y's stock. In addition, Y owns a royalty interest in an oil and gas property with a fair market value of $300,000 and an adjusted basis of $200,000. Under section 613A(c)(11)(B), Y's $200,000 adjusted basis in the royalty interest is allocated $100,000 to A and $100,000 to B. During 1996, A and B take depletion deductions with respect to the royalty interest of $10,000 and $15,000, respectively. As of January 1, 1997, A and B have a basis in the royalty interest of $90,000 and $85,000, respectively. On January 1, 1997, Y sells the royalty interest for $250,000. Under paragraph (a)(1) of this section, Y has gain recognized and recognized built-in gain of $75,000 ($250,000 − ($90,000 + $85,000) = $75,000) on the sale.

(b) *Accrual method rule*—(1) *Income items.* Except as otherwise provided in this section, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been properly included in gross income before the beginning of the recognition period by an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation).

(2) *Deduction items.* Except as otherwise provided in this section, any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period to an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation). In determining whether

an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer for purposes of this paragraph, section 461(h)(2)(C) and § 1.461–4(g) (relating to liabilities for tort, worker's compensation, breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts, taxes, and other liabilities) do not apply.

(3) *Examples*. The rules of this paragraph (b) are illustrated by the following examples.

Example 1. Accounts receivable. X is a C corporation using the cash method that elects to become an S corporation effective January 1, 1996. On January 1, 1996, X has $50,000 of accounts receivable for services rendered before that date. On that date, the accounts receivable have a fair market value of $40,000 and an adjusted basis of $0. In 1996, X collects $50,000 on the accounts receivable and includes that amount in gross income. Under paragraph (b)(1) of this section, the $50,000 included in gross income in 1996 is recognized built-in gain because it would have been included in gross income before the beginning of the recognition period if X had been an accrual method taxpayer. However, if X instead disposes of the accounts receivable for $45,000 on July 1, 1996, in a transaction treated as a sale or exchange for Federal income tax purposes, X would have recognized built-in gain of $40,000 on the disposition.

Example 2. Contingent liability. Y is a C corporation using the cash method that elects to become an S corporation effective January 1, 1996. In 1995, a lawsuit was filed against Y claiming $1,000,000 in damages. In 1996, Y loses the lawsuit, pays a $500,000 judgment, and properly claims a deduction for that amount. Under paragraph (b)(2) of this section, the $500,000 deduction allowed in 1996 is not recognized built-in loss because it would not have been allowed as a deduction against gross income before the beginning of the recognition period if Y had been an accrual method taxpayer (even disregarding section 461(h)(2)(C) and § 1.461–4(g)).

Example 3. Deferred payment liabilities. X is a C corporation using the cash method that elects to become an S corporation on January 1, 1996. In 1995, X lost a lawsuit and became obligated to pay $150,000 in damages. Under section 461(h)(2)(C), this amount is not allowed as a deduction until X makes payment. In 1996, X makes payment and properly claims a deduction for the amount of the payment. Under paragraph (b)(2) of this section, the $150,000 deduction allowed in 1996 is recognized built-in loss because it would have been allowed as a deduction against gross income before the beginning of the recognition period if X had been an accrual method taxpayer (disregarding section 461(h)(2)(C) and § 1.461–4(g)).

Example 4. Deferred prepayment income. Y is a C corporation using an accrual method that elects to become an S corporation effective January 1, 1996. In 1995, Y received $2,500 for services to be rendered in 1996, and properly elected to include the $2,500 in gross income in 1996 under Rev. Proc. 71–21, 1971–2 C.B. 549 (see § 601.601(d)(2)(ii)(*b*) of this chapter). Under paragraph (b)(1) of this section, the $2,500 included in gross income in 1996 is not recognized built-in gain because it would not have been included in gross income before the beginning of the recognition period by an accrual method taxpayer using the method that Y actually used before the beginning of the recognition period.

Example 5. Change in method. X is a C corporation using an accrual method that elects to become an S corporation effective January 1, 1996. In 1995, X received $5,000 for services to be rendered in 1996, and properly included the $5,000 in gross income. In 1996, X properly elects to include the $5,000 in gross income in 1996 under Rev. Proc. 71–21, 1971–2 C.B. 549 (see § 601.601(d)(2)(ii)(*b*) of this chapter). As a result of the change in method of accounting, X has a $5,000 negative section 481(a) adjustment. Under paragraph (b)(1) of this section, the $5,000 included in gross income in 1996 is recognized built-in gain because it would have been included in gross income before the beginning of the recognition period by an accrual method taxpayer using the method that X actually used before the beginning of the recognition period. In addition, the $5,000 negative section 481(a) adjustment is recognized built-in loss because it relates to an item (the $5,000 X received for services in 1995) attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section. See paragraph (d) of this section for rules regarding section 481(a) adjustments.

(c) *Section 267(a)(2) and 404(a)(5) deductions*—(1) *Section 267(a)(2)*. Notwithstanding paragraph (b)(2) of this section, any amount properly deducted in the recognition period under section 267(a)(2), relating to payments to related parties, is recognized built-in loss to the extent—

(i) All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and

(ii) The amount is paid—

(A) In the first two and one-half months of the recognition period; or

(B) To a related party owning, under the attribution rules of section 267, less than 5 percent, by voting power and value, of the corporation's stock, both as of the beginning of the recognition period and when the amount is paid.

(2) *Section 404(a)(5).* Notwithstanding paragraph (b)(2) of this section, any amount properly deducted in the recognition period under section 404(a)(5), relating to payments for deferred compensation, is recognized built-in loss to the extent—

(i) All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and

(ii) The amount is not paid to a related party to which section 267(a)(2) applies.

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

Example 1. Fixed annuity. X is a C corporation that elects to become an S corporation effective January 1, 1996. On December 31, 1995, A is age 60, has provided services to X as an employee for 20 years, and is a vested participant in X's unfunded nonqualified retirement plan. Under the plan, A receives $1,000 per month upon retirement until death. The plan provides no additional benefits. A retires on December 31, 1997, after working for X for 22 years. A at no time is a shareholder of X. X's deductions under section 404(a)(5) in the recognition period on paying A the $1,000 per month are recognized built-in loss because all events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period.

Example 2. Increase in annuity for working beyond 20 years. The facts are the same as *Example 1,* except that under the plan A receives $1,000 per month, plus $100 per month for each year A works for X beyond 20 years, upon retirement until death. X's deductions on paying A the $1,000 per month are recognized built-in loss. However, X's deductions on paying A the $200 per month for the two years A worked for X beyond 20 years are not recognized built-in loss because all events have not occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability cannot be determined, as of the beginning of the recognition period.

Example 3. Cost of living adjustment. The facts are the same as *Example 1,* except that under the plan A receives $1,000 per month, plus annual cost of living adjustments, upon retirement until death. X's deductions under section 404(a)(5) on paying A the $1,000 per month are recognized built-in loss. However, X's deductions under section 404(a)(5) on paying A the annual cost of living adjustment are not recognized built-in loss because all events have not occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability cannot be determined, as of the beginning of the recognition period.

(d) *Section 481(a) adjustments*—(1) *In general.* Any section 481(a) adjustment taken into account in the recognition period is recognized built-in gain or loss to the extent the adjustment relates to items attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section. The principles for determining recognized built-in gain or loss in this section include, for example, the accrual method rule under paragraph (b) of this section.

(2) *Examples.* The rules of this paragraph (d) are illustrated by the following examples.

Example 1. Omitted item attributable to prerecognition period. X is a C corporation that elects to become an S corporation effective January 1, 1996. X improperly capitalizes repair costs and recovers the costs through depreciation of the related assets. In 1999, X properly changes to deducting repair costs as they are incurred. Under section 481(a), the basis of the related assets are reduced by an amount equal to the excess of the repair costs incurred before the year of change over the repair costs recovered through depreciation before the year of change. In addition, X has a negative section 481(a) adjustment equal to the basis reduction. Under paragraph (d)(1) of this section, the portion of X's negative section 481(a) adjustment relating to the repair costs incurred before the recognition period is recognized built-in loss because those repair costs are items attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section.

Example 2. Duplicated item attributable to prerecognition period. Y is a C corporation that elects to become an S corporation effective January 1, 1996. Y improperly uses an accrual method without regard to the economic performance rules of section 461(h) to account for worker's compensation claims.

As a result, Y takes deductions when claims are filed. In 1999, Y properly changes to an accrual method with regard to the economic performance rules under section 461(h)(2)(C) for worker's compensation claims. As a result, Y takes deductions when claims are paid. The positive section 481(a) adjustment resulting from the change is equal to the amount of claims filed, but unpaid, before the year of change. Under paragraph (b)(2) of this section, the deduction allowed in the recognition period for claims filed, but unpaid, before the recognition period is recognized built-in loss because a deduction was allowed for those claims before the recognition period under an accrual method without regard to section 461(h)(2)(C). Under paragraph (d)(1) of this section, the portion of Y's positive section 481(a) adjustment relating to claims filed, but unpaid, before the recognition period is recognized built-in gain because those claims are items attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section.

(e) *Section 995(b)(2) deemed distributions*. Any item of income properly taken into account during the recognition period under section 995(b)(2) is recognized built-in gain if the item results from a DISC termination or disqualification occurring before the beginning of the recognition period.

(f) *Discharge of indebtedness and bad debts*. Any item of income or deduction properly taken into account during the first year of the recognition period as discharge of indebtedness income under section 61(a)(12) or as a bad debt deduction under section 166 is recognized built-in gain or loss if the item arises from a debt owed by or to an S corporation at the beginning of the recognition period.

(g) *Completion of contract*. Any item of income properly taken into account during the recognition period under the completed contract method (as described in §1.460–4(d)) where the corporation began performance of the contract before the beginning of the recognition period is recognized built-in gain if the item would have been included in gross income before the beginning of the recognition period under the percentage of completion method (as described in §1.460–4(b)). Any similar item of deduction is recognized built-in loss if the item would have been allowed as a deduction against gross income before the beginning of the recognition period under the percentage of completion method.

(h) *Installment method*—(1) *In general*. If a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method under section 453 during or after the recognition period, that income is subject to tax under section 1374.

(2) *Limitation on amount subject to tax*. For purposes of paragraph (h)(1) of this section, the taxable income limitation under §1.1374–2(a)(2) is equal to the amount by which the S corporation's net recognized built-in gain would have been increased from the year of the sale to the earlier of the year the income is reported under the installment method or the last year of the recognition period, assuming all income from the sale had been reported in the year of the sale and all provisions of section 1374 applied. For purposes of the preceding sentence, if the corporation sells the asset before the recognition period, the income from the sale that is not reported before the recognition period is treated as having been reported in the first year of the recognition period.

(3) *Rollover rule*. If the limitation in paragraph (h)(2) of this section applies, the excess of the amount reported under the installment method over the amount subject to tax under the limitation is treated as if it were reported in the succeeding taxable year(s), but only for succeeding taxable year(s) in the recognition period. The amount reported in the succeeding taxable year(s) under the preceding sentence is reduced to the extent that the amount not subject to tax under the limitation in paragraph (h)(2) of this section was not subject to tax because the S corporation had an excess of recognized built-in loss over recognized built-in gain in the taxable year of the sale and succeeding taxable year(s) in the recognition period.

(4) *Use of losses and section 1374 attributes*. If income is reported under the installment method by an S corporation for a taxable year after the recognition period and the income is subject to tax under paragraph (h)(1) of this section, the S corporation's section 1374 attributes may be used to the

extent their use is allowed under all applicable provisions of the Code in determining the section 1374 tax. However, the S corporation's loss recognized for a taxable year after the recognition period that would have been recognized built-in loss if it had been recognized in the recognition period may not be used in determining the section 1374 tax.

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

Example 1. Rollover rule. X is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, X sells Blackacre with a basis of $0 and a value of $100,000 in exchange for a $100,000 note bearing a market rate of interest payable on January 1, 2001. X does not make the election under section 453(d) and, therefore, reports the $100,000 gain using the installment method under section 453. In the year 2001, X has income of $100,000 on collecting the note, unexpired C year attributes of $0, recognized built-in loss of $0, current losses of $100,000, and taxable income of $0. If X had reported the $100,000 gain in 1996, X's net recognized built-in gain from 1996 through 2001 would have been $75,000 greater than otherwise. Under paragraph (h) of this section, X has $75,000 net recognized built-in gain subject to tax under section 1374. X also must treat the $25,000 excess of the amount reported, $100,000, over the amount subject to tax, $75,000, as income reported under the installment method in the succeeding taxable year(s) in the recognition period, except to the extent X establishes that the $25,000 was not subject to tax under section 1374 in the year 2001 because X had an excess of recognized built-in loss over recognized built-in gain in the taxable year of the sale and succeeding taxable year(s) in the recognition period.

Example 2. Use of losses. Y is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, Y sells Whiteacre with a basis of $0 and a value of $250,000 in exchange for a $250,000 note bearing a market rate of interest payable on January 1, 2006. Y does not make the election under section 453(d) and, therefore, reports the $250,000 gain using the installment method under section 453. In the year 2006, Y has income of $250,000 on collecting the note, unexpired C year attributes of $0, loss of $100,000 that would have been recognized built-in loss if it had been recognized in the recognition period, current losses of $150,000, and taxable income of $0. If Y had reported the $250,000 gain in 1996, X's net recognized built-in gain from 1996 through 2005 (that is, during the recognition period) would have been $225,000 greater than otherwise. Under paragraph (h) of this section, X has $225,000 net recognized built-in gain subject to tax under section 1374.

Example 3. Use of section 1374 attribute. Z is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, Z sells Greenacre with a basis of $0 and a value of $500,000 in exchange for a $500,000 note bearing a market rate of interest payable on January 1, 2011. Z does not make the election under section 453(d) and, therefore, reports the $500,000 gain using the installment method under section 453. In the year 2011, Z has income of $500,000 on collecting the note, loss of $0 that would have been recognized built-in loss if it had been recognized in the recognition period, current losses of $0, taxable income of $500,000, and a minimum tax credit of $60,000 arising in 1995. None of Z's minimum tax credit is limited under sections 53(c) or 383. If Z had reported the $500,000 gain in 1996, Z's net recognized built-in gain from 1996 through 2005 (that is, during the recognition period) would have been $350,000 greater than otherwise. Under paragraph (h) of this section, Z has $350,000 net recognized built-in gain subject to tax under section 1374, a tentative section 1374 tax of $122,500 ($350,000 × .35 = $122,500), and a section 1374 tax after using its minimum tax credit arising in 1995 of $62,250 ($122,500 − $60,000 = $62,250).

(i) *Partnership interests*—(1) *In general*. If an S corporation owns a partnership interest at the beginning of the recognition period or transfers property to a partnership in a transaction to which section 1374(d)(6) applies during the recognition period, the S corporation determines the effect on net recognized built-in gain from its distributive share of partnership items as follows—

(i) Step One: Apply the rules of section 1374(d) to the S corporation's distributive share of partnership items of income, gain, loss, or deduction included in income or allowed as a deduction under the rules of subchapter K to determine the extent to which it would have been treated as recognized built-in gain or loss if the partnership items had originated in and been taken into account directly by the S corporation (partnership 1374 items);

(ii) Step Two: Determine the S corporation's net recognized built-in gain without partnership 1374 items;

(iii) Step Three: Determine the S corporation's net recognized built-in gain with partnership 1374 items; and

(iv) Step Four: If the amount computed under Step Three (paragraph (i)(1)(iii) of this section) exceeds the amount computed under Step Two (paragraph (i)(1)(ii) of this section), the excess (as limited by paragraph (i)(2)(i) of this section) is the S corporation's partnership RBIG, and the S corporation's net recognized built-in gain is the sum of the amount computed under Step Two (paragraph (i)(1)(ii) of this section) plus the partnership RBIG. If the amount computed under Step Two (paragraph (i)(1)(ii) of this section) exceeds the amount computed under Step Three (paragraph (i)(1)(iii) of this section), the excess (as limited by paragraph (i)(2)(ii) of this section) is the S corporation's partnership RBIL, and the S corporation's net recognized built-in gain is the remainder of the amount computed under Step Two (paragraph (i)(1)(ii) of this section) after subtracting the partnership RBIL.

(2) *Limitations*—(i) *Partnership RBIG.* An S corporation's partnership RBIG for any taxable year may not exceed the excess (if any) of the S corporation's RBIG limitation over its partnership RBIG for prior taxable years. The preceding sentence does not apply if a corporation forms or avails of a partnership with a principal purpose of avoiding the tax imposed under section 1374.

(ii) *Partnership RBIL.* An S corporation's partnership RBIL for any taxable year may not exceed the excess (if any) of the S corporation's RBIL limitation over its partnership RBIL for prior taxable years.

(3) *Disposition of partnership interest.* If an S corporation disposes of its partnership interest, the amount that may be treated as recognized built-in gain may not exceed the excess (if any) of the S corporation's RBIG limitation over its partnership RBIG during the recognition period. Similarly, the amount that may be treated as recognized built-in loss may not exceed the excess (if any) of the S corporation's RBIL limitation over its partnership RBIL during the recognition period.

(4) *RBIG and RBIL limitations*—(i) *Sale of partnership interest.* An S corporation's RBIG or RBIL limitation is the total of the following—

(A) The amount that would be the amount realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold its partnership interest (and any assets the corporation contributed to the partnership during the recognition period) at fair market value to an unrelated party; decreased by

(B) The corporation's adjusted basis in the partnership interest (and any assets the corporation contributed to the partnership during the recognition period) at the time of the sale referred to in paragraph (i)(4)(i)(A) of this section; and increased or decreased by

(C) The corporation's allocable share of the partnership's section 481(a) adjustments at the time of the sale referred to in paragraph (i)(4)(i)(A) of this section.

(ii) *Amounts of limitations.* If the result in paragraph (i)(4)(i) of this section is a positive amount, the S corporation has a RBIG limitation equal to that amount and a RBIL limitation of $0, but if the result in paragraph (i)(4)(i) of this section is a negative amount, the S corporation has a RBIL limitation equal to that amount and a RBIG limitation of $0.

(5) *Small interest exception*—(i) *In general.* Paragraph (i)(1) of this section does not apply to a taxable year in the recognition period if the S corporation's partnership interest represents less than 10 percent of the partnership's capital and profits at all times during the taxable year and prior taxable years in the recognition period, and the fair market value of the S corporation's partnership interest as of the beginning of the recognition period is less than $100,000.

(ii) *Contributed assets.* For purposes of paragraph (i)(5)(i) of this section, if the S corporation contributes any assets to the partnership during the recognition period and the S corporation held the assets as of the beginning of the recognition period, the fair market value of the S corporation's partnership interest as of the beginning of the recognition period is determined as if the assets were contributed to the partnership before the beginning of the recognition period (using the fair market value of each contributed asset as of

the beginning of the recognition period). The contribution does not affect whether paragraph (i)(5)(i) of this section applies for taxable years in the recognition period before the taxable year in which the contribution was made.

(iii) *Anti-abuse rule.* Paragraph (i)(5)(i) of this section does not apply if a corporation forms or avails of a partnership with a principal purpose of avoiding the tax imposed under section 1374.

(6) *Section 704(c) gain or loss.* Solely for purposes of section 1374, an S corporation's section 704(c) gain or loss amount with respect to any asset is not reduced during the recognition period, except for amounts treated as recognized built-in gain or loss with respect to that asset under this paragraph.

(7) *Disposition of distributed partnership asset.* If on the first day of the recognition period an S corporation holds an interest in a partnership that holds an asset and during the recognition period the partnership distributes the asset to the S corporation that thereafter disposes of the asset, the asset is treated as having been held by the S corporation on the first day of the recognition period and as having the fair market value and adjusted basis in the hands of the S corporation that it had in the hands of the partnership on that day.

(8) *Examples.* The rules of this paragraph (i) are illustrated by the following examples.

Example 1. Pre-conversion partnership interest. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a 50 percent interest in partnership P and P owns (among other assets) Blackacre with a basis of $25,000 and a value of $45,000. In 1996, P buys Whiteacre for $50,000. In 1999, P sells Blackacre for $55,000 and recognizes a gain of $30,000 of which $15,000 is included in X's distributive share. P also sells Whiteacre in 1999 for $42,000 and recognizes a loss of $8,000 of which $4,000 is included in X's distributive share. Under this paragraph and section 1374(d)(3), X's $15,000 gain is presumed to be recognized built-in gain and thus treated as a partnership 1374 item, but this presumption is rebutted if X establishes that P's gain would have been only $20,000 ($45,000 − $25,000 = $20,000) if Blackacre had been sold on the first day of the recognition period. In such a case, only X's distributive share of the $20,000 built-in gain, $10,000, would be treated as a partnership 1374 item. Under this paragraph and section 1374(d)(4), X's $4,000 loss is not treated as a partnership 1374 item because P did not hold Whiteacre on the first day of the recognition period.

Example 2. Post-conversion contribution. Y is a C corporation that elects to become an S corporation on January 1, 1996. On that date, Y owns (among other assets) Blackacre with a basis of $100,000 and a value of $200,000. On January 1, 1998, when Blackacre has a basis of $100,000 and a value of $200,000, Y contributes Blackacre to partnership P for a 50 percent interest in P. On January 1, 2000, P sells Blackacre for $300,000 and recognizes a gain of $200,000 on the sale ($300,000 − $100,000 = $200,000). P is allocated $100,000 of the gain under section 704(c), and another $50,000 of the gain for its fifty percent share of the remainder, for a total of $150,000. Under this paragraph and section 1374(d)(3), if Y establishes that P's gain would have been only $100,000 ($200,000 − $100,000 = $100,000) if Blackacre had been sold on the first day of the recognition period, Y would treat only $100,000 as a partnership 1374 item.

Example 3. RBIG limitation of $100,000 or $50,000. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a 50 percent interest in partnership P with a RBIG limitation of $100,000 and a RBIL limitation of $0. P owns (among other assets) Blackacre with a basis of $50,000 and a value of $200,000. In 1996, P sells Blackacre for $200,000 and recognizes a gain of $150,000 of which $75,000 is included in X's distributive share and treated as a partnership 1374 item. X's net recognized built-in gain for 1996 computed without partnership 1374 items is $35,000 and with partnership 1374 items is $110,000. Thus, X has a partnership RBIG of $75,000 except as limited under paragraph (i)(2)(i) of this section. Because X's RBIG limitation is $100,000, X's partnership RBIG of $75,000 is not limited and X's net recognized built-in gain for the year is $110,000 ($35,000 + $75,000 = $110,000). However, if X had a RBIG limitation of $50,000 instead of $100,000, X's partnership RBIG would be limited to $50,000 under paragraph (i)(2)(i) of this section and X's net recognized built-in gain would be $85,000 ($35,000 + $50,000 = $85,000).

Example 4. RBIL limitation of $60,000 or $40,000. Y is a C corporation that elects to become an S corporation on January 1, 1996. On that date, Y owns a 50 percent interest in partnership P with a RBIG limitation of $0 and a RBIL limitation of $60,000. P owns (among other assets) Blackacre with a basis of $225,000 and a value of $125,000. In 1996, P sells Blackacre for $125,000 and recognizes a loss of $100,000 of which $50,000 is included in Y's distributive share and treated as a partnership 1374 item. Y's net recognized built-in gain for 1996 computed without partnership

1374 items is $75,000 and with partnership 1374 items is $25,000. Thus, Y has a partnership RBIL of $50,000 for the year except as limited under paragraph (i)(2)(ii) of this section. Because Y's RBIL limitation is $60,000, Y's partnership RBIL for the year is not limited and Y's net recognized built-in gain for the year is $25,000 ($75,000 − $50,000 = $25,000). However, if Y had a RBIL limitation of $40,000 instead of $60,000, Y's partnership RBIL would be limited to $40,000 under paragraph (i)(2)(ii) of this section and Y's net recognized built-in gain for the year would be $35,000 ($75,000 − $40,000 = $35,000).

Example 5. RBIG limitation of $0. (i) X is a C corporation that elects to become an S corporation on January 1, 1996. X owns a 50 percent interest in partnership P with a RBIG limitation of $0 and a RBIL limitation of $25,000.

(a) In 1996, P's partnership 1374 items are—

(1) Ordinary income of $25,000; and

(2) Capital gain of $75,000.

(b) X itself has—

(1) Recognized built-in ordinary income of $40,000; and

(2) Recognized built-in capital loss of $90,000.

(ii) X's net recognized built-in gain for 1996 computed without partnership 1374 items is $40,000 and with partnership 1374 items is $65,000 ($40,000 + $25,000 = $65,000). Thus, X's partnership RBIG is $25,000 for the year except as limited under paragraph (i)(2)(i) of this section. Because X's RBIG limitation is $0, X's partnership RBIG of $25,000 is limited to $0 and X's net recognized built-in gain for the year is $40,000.

Example 6. RBIL limitation of $0. (i) Y is a C corporation that elects to become an S corporation on January 1, 1996. Y owns a 50 percent interest in partnership P with a RBIG limitation of $60,000 and a RBIL limitation of $0.

(a) In 1996, P's partnership 1374 items are—

(1) Ordinary income of $25,000; and

(2) Capital loss of $90,000.

(b) Y itself has—

(1) recognized built-in ordinary income of $40,000; and

(2) recognized built-in capital gain of $75,000.

(ii) Y's net recognized built-in gain for 1996 computed without partnership 1374 items is $115,000 ($40,000 + $75,000 = $115,000) and with partnership 1374 items is $65,000 ($40,000 + $25,000 = $65,000). Thus, Y's partnership RBIL is $50,000 for the year except as limited under paragraph (i)(2)(ii) of this section. Because Y's RBIL limitation is $0, Y's partnership RBIL of $50,000 is limited to $0 and Y's net recognized built-in gain is $115,000.

Example 7. Disposition of partnership interest. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a 50 percent interest in partnership P with a RBIG limitation of $200,000 and a RBIL limitation of $0. P owns (among other assets) Blackacre with a basis of $20,000 and a value of $140,000. In 1996, P sells Blackacre for $140,000 and recognizes a gain of $120,000 of which $60,000 is included in X's distributive share and treated as a partnership 1374 item. X's net recognized built-in gain for 1996 computed without partnership 1374 items is $95,000 and with partnership 1374 items is $155,000. Thus, X has a partnership RBIG of $60,000. In 1999, X sells its entire interest in P for $350,000 and recognizes a gain of $250,000. Under paragraph (i)(3) of this section, X's recognized built-in gain on the sale is limited by its RBIG limitation to $140,000 ($200,000 − $60,000 = $140,000).

Example 8. Section 704(c) case. Y is a C corporation that elects to become an S corporation on January 1, 1996. On that date, Y contributes Asset 1, 5-year property with a value of $40,000 and a basis of $0, and an unrelated party contributes $40,000 in cash, each for a 50 percent interest in partnership P. The partnership adopts the traditional method under § 1.704–3(b). If P sold Asset 1 for $40,000 immediately after it was contributed by Y, P's $40,000 gain would be allocated to Y under section 704(c). Instead, Asset 1 is sold by P in 1999 for $36,000 and P recognizes gain of $36,000 ($36,000 − $0 = $36,000) on the sale. However, because book depreciation of $8,000 per year has been taken on Asset 1 in 1996, 1997, and 1998, Y is allocated only $16,000 of P's $36,000 gain ($40,000 − (3 × $8,000) = ($16,000 − $0) = $16,000) under section 704(c). The remaining $20,000 of P's $36,000 gain ($36,000 − $16,000 = $20,000) is allocated 50 percent to each partner under section 704(b). Thus, a total of $26,000 ($16,000 + $10,000 = $26,000) of P's $36,000 gain is allocated to Y. However, under paragraph (i)(6) of this section, Y treats $36,000 as a partnership 1374 item on P's sale of Asset 1.

Example 9. Disposition of distributed partnership asset. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a fifty percent interest in partnership P and P owns (among other assets) Blackacre with a basis of $20,000 and a value of $40,000. On January 1, 1998, P distributes Blackacre to X, when Blackacre has a basis of $20,000 and a value of $50,000. Under section 732(a)(1), X has a transferred basis of $20,000 in Blackacre. On January 1, 1999, X sells Blackacre for $60,000 and recognizes a gain of $40,000. Under paragraph (i)(7) of this section and section 1374(d)(3), X has recognized built-in gain from the sale of $20,000, the amount of built-in gain in Blackacre on the first day of the recognition period.

[T.D. 8579, 59 FR 66464, Dec. 27, 1994, as amended by T.D. 8995. 67 FR 34610, May 15, 2002]

§ 1.1374–5 Loss carryforwards.

(a) *In general*. The loss carryforwards allowed as deductions against net recognized built-in gain under section 1374(b)(2) are allowed only to the extent their use is allowed under the rules applying to C corporations. Any other loss carryforwards, such as charitable contribution carryforwards under section 170(d)(2), are not allowed as deductions against net recognized built-in gain.

(b) *Example*. The rules of this section are illustrated by the following example.

Example: Section 382 limitation. X is a C corporation that has an ownership change under section 382(g)(1) on January 1, 1994. On that date, X has a fair market value of $500,000, NOL carryforwards of $400,000, and a net unrealized built-in gain under section 382(h)(3)(A) of $0. Assume X's section 382 limitation under section 382(b)(1) is $40,000. X elects to become an S corporation on January 1, 1998. On that date, X has NOL carryforwards of $240,000 (having used $160,000 of its pre-change net operating losses in its 4 preceding taxable years) and a section 1374 net unrealized built-in gain of $250,000. In 1998, X has net recognized built-in gain of $100,000. X may use $40,000 of its NOL carryforwards as a deduction against its $100,000 net recognized built-in gain, because X's section 382 limitation is $40,000.

[T.D. 8579, 59 FR 66469, Dec. 27, 1994]

§ 1.1374–6 Credits and credit carryforwards.

(a) *In general*. The credits and credit carryforwards allowed as credits against the section 1374 tax under section 1374(b)(3) are allowed only to the extent their use is allowed under the rules applying to C corporations. Any other credits or credit carryforwards, such as foreign tax credits under section 901, are not allowed as credits against the section 1374 tax.

(b) *Limitations*. The amount of business credit carryforwards and minimum tax credit allowed against the section 1374 tax are subject to the limitations described in section 38(c) and section 53(c), respectively, as modified by this paragraph. The tentative tax determined under paragraph (a)(3) of § 1.1374–1 is treated as the regular tax liability described in sections 38(c)(1) and 53(c)(1), and as the net income tax and net regular tax liability described in section 38(c)(1). The tentative minimum tax described in section 55(b) is determined using the rate of tax applicable to corporations and without regard to any alternative minimum tax foreign tax credit described in that section and by treating the net recognized built-in gain determined under § 1.1374–2, modified to take into account the adjustments of sections 56 and 58 applicable to corporations and the preferences of section 57, as the alternative minimum taxable income described in section 55(b)(2).

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

Example 1. Business credit carryforward. X is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, X has a $500,000 business credit carryforward from a C year and Asset #1 with a fair market value of $400,000, a basis for regular tax purposes of $95,000, and a basis for alternative minimum tax purposes of $150,000. In 1996, X has net recognized built-in gain of $305,000 from selling Asset #1 for $400,000. Thus, X's tentative tax under paragraph (a)(3) of § 1.1374–1 and regular tax liability under paragraph (b) of this section is $106,750 ($400,000 − $95,000 = $305,000 × .35= $106,750, assuming a 35 percent tax rate). Also, X's tentative minimum tax determined under paragraph (b) of this section is $47,000 [$400,000 − $150,000 = $250,000 − $15,000 ($40,000 corporate exemption amount − $25,000 phase-out = $15,000) = $235,000 × .20 = $47,000, assuming a 20 percent tax rate]. Thus, the business credit limitation under section 38(c) is $59,750 [$106,750 − $47,000 (the greater of $47,000 or $20,438 (.25 × $81,750 ($106,750 − $25,000 = $81,750))) = $59,750]. As a result, X's section 1374 tax is $47,000 ($106,750 − $59,750= $47,000) for 1996 and X has $440,250 ($500,000 − $59,750 = $440,250) of business credit carryforwards for succeeding taxable years.

Example 2. Minimum tax credit. Y is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, Asset#1 has a fair market value of $5,000,000, a basis for regular tax purposes of $4,000,000, and a basis for alternative minimum tax purposes of $4,750,000. Y also has a minimum tax credit of $310,000 from 1995. Y has no other assets, no net operating or capital loss carryforwards, and no business credit carryforwards. In 1996, Y's only transaction is the sale of Asset #1 for $5,000,000. Therefore, Y has net recognized built-in gain in 1996 of $1,000,000 ($5,000,000 − $4,000,000 = $1,000,000) and a tentative tax under paragraph (a)(3) of § 1.1374–1 of $350,000 ($1,000,000 × .35 = $350,000, assuming a 35 percent tax

rate). Also, Y's tentative minimum tax determined under paragraph (b) of this section is $47,000 [$5,000,000 − $4,750,000 = $250,000 − $15,000 ($40,000 corporate exemption amount − $25,000 phase-out = $15,000) = $235,000 × .20 = $47,000, assuming a 20 percent tax rate]. Thus, Y may use its minimum tax credit in the amount of $303,000 ($350,000 − $47,000 = $303,000) to offset its section 1374 tentative tax. As a result, Y's section 1374 tax is $47,000 ($350,000 − $303,000 = $47,000) in 1996 and Y has a minimum tax credit attributable to years for which Y was a C corporation of $7,000 ($310,000 − $303,000 = $7,000).

[T.D. 8579, 59 FR 66469, Dec. 27, 1994]

§ 1.1374–7 Inventory.

(a) *Valuation.* The fair market value of the inventory of an S corporation on the first day of the recognition period equals the amount that a willing buyer would pay a willing seller for the inventory in a purchase of all the S corporation's assets by a buyer that expects to continue to operate the S corporation's business. For purposes of the preceding sentence, the buyer and seller are presumed not to be under any compulsion to buy or sell and to have reasonable knowledge of all relevant facts.

(b) *Identity of dispositions.* The inventory method used by an S corporation for tax purposes must be used to identify whether the inventory it disposes of during the recognition period is inventory it held on the first day of that period. Thus, a corporation using the LIFO method does not dispose of inventory it held on the first day of the recognition period unless the carrying value of its inventory for a taxable year during that period is less than the carrying value of its inventory on the first day of the recognition period (determined using the LIFO method as described in section 472). However, if a corporation changes its method of accounting for inventory (for example, from the FIFO method to the LIFO method or from the LIFO method to the FIFO method) with a principal purpose of avoiding the tax imposed under section 1374, it must use its former method to identify its dispositions of inventory.

[T.D. 8579, 59 FR 66469, Dec. 27, 1994]

§ 1.1374–8 Section 1374(d)(8) transactions.

(a) *In general.* If any S corporation acquires any asset in a transaction in which the S corporation's basis in the asset is determined (in whole or in part) by reference to a C corporation's basis in the assets (or any other property) (a section 1374(d)(8) transaction), section 1374 applies to the net recognized built-in gain attributable to the assets acquired in any section 1374(d)(8) transaction.

(b) *Effective date of section 1374(d)(8).* Section 1374(d)(8) applies to any section 1374(d)(8) transaction, as defined in paragraph (a)(1) of this section, that occurs on or after December 27, 1994, without regard to the date of the corporation's election to be an S corporation under section 1362.

(c) *Separate determination of tax.* For purposes of the tax imposed under section 1374(d)(8), a separate determination of tax is made with respect to the assets the S corporation acquires in one section 1374(d)(8) transaction from the assets the S corporation acquires in another section 1374(d)(8) transaction and from the assets the corporation held when it became an S corporation. Thus, an S corporation's section 1374 attributes when it became an S corporation may only be used to reduce the section 1374 tax imposed on dispositions of assets the S corporation held at that time. Similarly, an S corporation's section 1374 attributes acquired in a section 1374(d)(8) transaction may only be used to reduce a section 1374 tax imposed on dispositions of assets the S corporation acquired in the same transaction. If an S corporation makes QSub elections under section 1361(b)(3) for a tiered group of subsidiaries effective on the same day, see § 1.1361–4(b)(2).

(d) *Taxable income limitation.* For purposes of paragraph (a) of this section, an S corporation's taxable income limitation under § 1.1374–2(a)(2) for any taxable year is allocated between or among each of the S corporation's separate determinations of net recognized built-in gain for that year (determined without regard to the taxable income limitation) based on the ratio of each of those determinations to the sum of all of those determinations.

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

Example 1. Separate determination of tax. (i) X is a C corporation that elected to become an S corporation effective January 1, 1986 (before section 1374 was amended in the Tax Reform Act of 1986). X has a net operating loss carryforward of $20,000 arising in 1985 when X was a C corporation. On January 1, 1996, Y (an unrelated C corporation) merges into X in a transaction to which section 368(a)(1)(A) applies. Y has no loss carryforwards, credits, or credit carryforwards. The assets X acquired from Y are subject to tax under section 1374 and have a net unrealized built-in gain of $150,000.

(ii) In 1996, X has a pre-limitation amount of $50,000 on dispositions of assets acquired from Y and a taxable income limitation of $100,000 (because only one group of assets is subject to section 1374, there is no allocation of the taxable income limitation). As a result, X has a net recognized built-in gain on those assets of $50,000. X's $20,000 net operating loss carryforward may not be used as a deduction against its $50,000 net recognized built-in gain on the assets X acquired from Y. Therefore, X has a section 1374 tax of $17,500 ($50,000 × .35 = $17,500, assuming a 35 percent tax rate) for its 1996 taxable year.

Example 2. Allocation of taxable income limitation. (i) Y is a C corporation that elects to become an S corporation effective January 1, 1996. The assets Y holds when it becomes an S corporation have a net unrealized built-in gain of $5,000. Y has no loss carryforwards, credits, or credit carryforwards. On January 1, 1997, Z (an unrelated C corporation) merges into Y in a transaction to which section 368(a)(1)(A) applies. Z has no loss carryforwards, credits, or credit carryforwards. The assets Y acquired from Z are subject to tax under section 1374 and have a net unrealized built-in gain of $80,000.

(ii) In 1997, Y has a pre-limitation amount on the assets it held when it became an S corporation of $15,000, a pre-limitation amount on the assets Y acquired from Z of $15,000, and a taxable income limitation of $10,000. However, because the assets Y held on becoming an S corporation have a net unrealized built-in gain of $5,000, its net recognized built-in gain on those assets is limited to $5,000 before taking into account the taxable income limitation. Y's taxable income limitation of $10,000 is allocated between the assets Y held on becoming an S corporation and the assets Y acquired from Z for purposes of determining the net recognized built-in gain from each pool of assets. Thus, Y's net recognized built-in gain on the assets Y held on becoming an S corporation is $2,500 [$10,000 × ($5,000/$20,000) = $2,500]. Y's net recognized built-in gain on the assets Y acquired from Z is $7,500 [$10,000 × ($15,000/$20,000) = $7,500]. Therefore, Y has a section 1374 tax of $3,500 [($2,500 + $7,500) × .35 = $3,500, assuming a 35 percent tax rate] for its 1997 taxable year.

[T.D. 8579, 59 FR 66469, Dec. 27, 1994, as amended by T.D. 8869, 65 FR 3856, Jan. 25, 2000; T.D. 9170, 69 FR 76614, Dec. 22, 2004; T.D. 9236, 70 FR 75731, Dec. 21, 2005]

§ 1.1374–9 Anti-stuffing rule.

If a corporation acquires an asset before or during the recognition period with a principal purpose of avoiding the tax imposed under section 1374, the asset and any loss, deduction, loss carryforward, credit, or credit carryforward attributable to the asset is disregarded in determining the S corporation's pre-limitation amount, taxable income limitation, net unrealized built-in gain limitation, deductions against net recognized built-in gain, and credits against the section 1374 tax.

[T.D. 8579, 59 FR 66470, Dec. 27, 1994]

§ 1.1374–10 Effective date and additional rules.

(a) *In general*. Sections 1.1374–1 through 1.1374–9, other than § 1.1374–3(b) and (c) *Examples 2* through *4*, apply for taxable years ending on or after December 27, 1994, but only in cases where the S corporation's return for the taxable year is filed pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994. Section 1.1374–3(b) and (c) *Examples 2* through *4* apply to section 1374(d)(8) transactions that occur in taxable years beginning after February 23, 2005. In addition, an S corporation may apply § 1.1374–3(b) and (c) *Examples 2* through *4* to section 1374(d)(8) transactions that occur in taxable years beginning on or before February 23, 2005, if the S corporation (and any predecessors or successors) and all affected shareholders file original or amended returns that are consistent with these provisions for taxable years of the S corporation during the recognition period of the pool of assets the net unrealized built-in gain of which would be adjusted pursuant to those provisions that are not closed as of the first date after February 23, 2005, that the S corporation files an original or amended

return. For purposes of this section, affected shareholders means all shareholders who received distributive shares of S corporation items in such taxable years. However, the Commissioner may, in appropriate circumstances, permit taxpayers to apply these provisions even if all affected shareholders cannot file consistent returns. In addition, for this purpose, a predecessor of an S corporation is a corporation that transfers its assets to the S corporation in a transaction to which section 381 applies. A successor of an S corporation is a corporation to which the S corporation transfers its assets in a transaction to which section 381 applies.

(b) *Additional rules.* This paragraph (b) provides rules applicable to certain S corporations, assets, or transactions to which §§1.1374–1 through 1.1374–9 do not apply.

(1) *Certain transfers to partnerships.* If a corporation transfers an asset to a partnership in a transaction to which section 721(a) applies and the transfer is made in contemplation of an S election or during the recognition period, section 1374 applies on a disposition of the asset by the partnership as if the S corporation had disposed of the asset itself. This paragraph (b)(1) applies as of the effective date of section 1374, unless the recognition period with respect to the contributed asset is pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994.

(2) *Certain inventory dispositions.* For purposes of section 1374(d)(2)(A), the inventory method used by the taxpayer for tax purposes (FIFO, LIFO, etc.) must be used to identify whether goods disposed of following conversion to S corporation status were held by the corporation at the time of conversion. Thus, for example, a corporation using the LIFO inventory method will not be subject to the built-in gain tax with respect to sales of inventory except to the extent that a LIFO layer existing prior to the beginning of the first taxable year as an S corporation is invaded after the beginning of that year. This paragraph (b)(2) applies as of the effective date of section 1374, unless the recognition period with respect to the inventory is pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994.

(3) *Certain contributions of built-in loss assets.* If a built-in loss asset (that is, an asset with an adjusted tax basis in excess of its fair market value) is contributed to a corporation within 2 years before the earlier of the beginning of its first taxable year as an S corporation, or the filing of its S election, the loss inherent in the asset will not reduce net unrealized built-in gain, as defined in section 1374(d)(1), unless the taxpayer demonstrates a clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises. This paragraph (b)(3) applies as of the effective date of section 1374, unless the recognition period with respect to the contributed asset is pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994.

(4) *Certain installment sales*—(i) *In general.* If a taxpayer sells an asset either prior to or during the recognition period and recognizes income either during or after the recognition period from the sale under the installment method, the income will, when recognized, be taxed under section 1374 to the extent it would have been so taxed in prior taxable years if the selling corporation had made the election under section 453(d) not to report the income under the installment method. For purposes of determining the extent to which the income would have been subject to tax if the section 453(d) election had not been made, the taxable income limitation of section 1374(d)(2)(A)(ii) and the built-in gain carryover rule of section 1374(d)(2)(B) will be taken into account. This paragraph (b)(4) applies for installment sales occurring on or after March 26, 1990, and before December 27, 1994.

(ii) *Examples.* The rules of this paragraph (b)(4) are illustrated by the following examples.

Example 1. In year 1 of the recognition period under section 1374, a corporation realizes a gain of $100,000 on the sale of an asset with built-in gain. The corporation is to receive full payment for the asset in year 11. Because the corporation does not make an election under section 453(d), all $100,000 of the gain from the sale is reported under the

installment method in year 11. If the corporation had made an election under section 453(d) with respect to the sale, the gain would have been recognized in year 1 and, taking into account the corporation's income and gains from other sources, application of the taxable income limitation of section 1374(d)(2)(A)(ii) and the built-in gain carryover rule of section 1374(d)(2)(B) would have resulted in $40,000 of the gain being subject to tax during the recognition period under section 1374. Therefore, $40,000 of the gain recognized in year 11 is subject to tax under section 1374.

Example 2. In year 1 of the recognition period under section 1374, a corporation realizes a gain of $100,000 on the sale of an asset with built-in gain. The corporation is to receive full payment for the asset in year 6. Because the corporation does not make an election under section 453(d), all $100,000 of the gain from the sale is reported under the installment method in year 6. If the corporation had made an election under section 453(d) with respect to the sale, the gain would have been recognized in year 1 and, taking into account the corporation's income and gains from other sources, application of the taxable income limitation of section 1374(d)(2)(A)(ii) and the built-in gain carryover rule of section 1374(d)(2)(B) would have resulted in all of the gain being subjected to tax under section 1374 in years 1 through 5. Therefore, notwithstanding that the taxable income limitation of section 1374(d)(2)(A)(ii) might otherwise limit the taxation of the gain recognized in year 6, the entire $100,000 of gain will be subject to tax under section 1374 when it is recognized in year 6.

(c) *Termination and re-election of S corporation status*—(1) *In general.* For purposes of section 633(d)(8) of the Tax Reform Act of 1986, as amended, any reference to an election to be an S corporation under section 1362 shall be treated as a reference to the corporation's most recent election to be an S corporation under section 1362. This paragraph (c) applies for taxable years beginning after December 22, 2004, without regard to the date of the corporation's most recent election to be an S corporation under section 1362.

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

Example. (i) Effective January 1, 1988, X, a C corporation that is a qualified corporation under section 633(d) of the Tax Reform Act of 1986, as amended, elects to be an S corporation under section 1362. Effective January 1, 1990, X revokes its S status and becomes a C corporation. On January 1, 2004, X again elects to be an S corporation under section 1362. X disposes of assets in 2006, 2007, and 2008, recognizing gain.

(ii) X is not eligible for treatment under the transition rule of section 633(d)(8) of the Tax Reform Act of 1986, as amended, with respect to these assets. Accordingly, X is subject to section 1374, as amended by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988, and the 10-year recognition period begins on January 1, 2004.

(iii) To the extent the gain that X recognizes on the asset sales in 2006, 2007, and 2008 reflects built-in gain inherent in such assets in X's hands on January 1, 2004, such gain is subject to tax under section 1374 as amended by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988.

[T.D. 8579, 59 FR 66470, Dec. 27, 1994, as amended by T.D. 9170, 69 FR 76614, Dec. 22, 2004; T.D. 9180, 70 FR 8728, Feb. 23, 2005; T.D. 9236, 70 FR 75731, Dec. 21, 2005]

§ 1.1375–1 Tax imposed when passive investment income of corporation having subchapter C earnings and profits exceed 25 percent of gross receipts.

(a) *General rule.* For taxable years beginning after 1981, section 1375(a) imposes a tax on the income of certain S corporations that have passive investment income. In the case of a taxable year beginning during 1982, an electing small business corporation may elect to have the rules under this section not apply. See the regulations under section 1362 for rules on the election. For purposes of this section, the term *S corporation* shall include an electing small business corporation under prior law. This tax shall apply to an S corporation for a taxable year if the S corporation has—

(1) Subchapter C earnings and profits at the close of such taxable year, and

(2) Gross receipts more than 25 percent of which are passive investment income

If the S corporation has no subchapter C earnings and profits at the close of the taxable year (because, for example, such earnings and profits were distributed in accordance with section 1368), the tax shall not be imposed even though the S corporation has passive investment income for the taxable year. If the tax is imposed, the tax shall be computed by multiplying the excess net passive income (as defined

in paragraph (b) of this section) by the highest rate of tax specified in section 11(b).

(b) *Definitions*—(1) *Excess net passive income*—(i) *In general*. The term *excess net passive income* is defined in section 1375(b)(1), and can be expressed by the following formula:

$$\text{ENPI} = \text{NPI} \times \frac{\text{PII} - (.25 \times \text{GR})}{\text{PII}}$$

Where:

ENPI = excess net passive income
NPI = net passive income
PII = passive investment income
GR = total gross receipts

(ii) *Limitation*. The amount of the excess net passive income for any taxable year shall not exceed the corporation's taxable income for the taxable year (determined in accordance with section 1374(d) and § 1.1374–1(d)).

(2) *Net passive income*. The term *net passive income* means—

(i) Passive investment income, reduced by

(ii) The deductions allowable under chapter 1 of the Internal Revenue Code of 1954 which are directly connected (within the meaning of paragraph (b)(3) of this section) with the production of such income (other than deductions allowable under section 172 and part VIII of subchapter B).

(3) *Directly connected*—(i) *In general*. For purposes of paragraph (b)(2)(ii) of this section to be directly connected with the production of income, an item of deduction must have proximate and primary relationship to the income. Expenses, depreciation, and similar items attributable solely to such income qualify for deduction.

(ii) *Allocation of deduction*. If an item of deduction is attributable (within the meaning of paragraph (b)(3)(i) of this section) inpart to passive investment income and in part to income other than passive investment income, the deduction shall be allocated between the two types of items on a reasonable basis. The portion of any deduction so allocated to passive investment income shall be treated as proximately and primarily related to such income.

(4) *Other definitions*. The terms *subchapter C earnings and profits*, *passive investment income*, and *gross receipts* shall have the same meaning given these terms in section 1362(d)(3) and the regulations thereunder.

(c) *Special rules*—(1) *Disallowance of credits*. No credit is allowed under part IV of subchapter A of chapter 1 of the Code (other than section 34) against the tax imposed by section 1375(a) and this section.

(2) *Coordination with section 1374*. If any gain—

(i) Is taken into account in determining passive income for purposes of this section, and

(ii) Is taken into account under section 1374,

the amount of such gain taken into account under section 1374(b) and § 1.1374–1(b) (1) and (2) in determining the amount of tax shall be reduced by the portion of the excess net passive income for the taxable year which is attributable (on a pro rata basis) to such gain. For purposes of the preceding sentence, the portion of excess net passive income for the taxable year which is attributable to such capital gain is equal to the amount determined by multiplying the excess net passive income by the following fraction:

$$\frac{\text{NCG} - \text{E}}{\text{NPI}}$$

Where:

NCG = net capital gain
NPI = net passive income.
E = Expense attributable to net capital gain.

(d) *Waiver of tax in certain cases*—(1) *In general*. If an S corporation establishes to the satisfaction of the Commissioner that—

(i) It determined in good faith that it had no subchapter C earnings and profits at the close of the taxable year, and

(ii) During a reasonable period of time after it was determined that it did have subchapter C earnings and profits at the close of such taxable year such earnings and profits were distributed,

the Commissioner may waive the tax imposed by section 1375 for such taxable year. The S corporation has the burden of establishing that under the relevant facts and circumsances the Commissioner should waive the tax.

For example, if an S corporation establishes that in good faith and using

due diligence it determined that it had no subchapter C earnings and profits at the close of a taxable year, but it was later determined on audit that it did have subchapter C earnings and profits at the close of such taxable year, and if the corporation establishes that it distributed such earnings and profits within a reasonable time after the audit, it may be appropriate for the Commissioner to waive the tax on passive income for such taxable year.

(2) *Corporation's request for a waiver*. A request for waiver of the tax imposed by section 1375 shall be made in writing to the district director and shall contain all relevant facts to establish that the requirements of paragraph (d)(1) of this section are met. Such request shall contain a description of how and on what date the S corporation in good faith and using due diligence determined that it had no subchapter C earnings and profits at the close of the taxable year, a description of how and on what date it was determined that the S corporation had subchapter C earnings and profits at the close of the year and a description (including dates) of any steps taken to distribute such earnings and profits. If the earnings and profits have not yet been distributed, the request shall contain a timetable for distribution and an explanation of why such timetable is reasonable. On the date the waiver is to become effective, all subchapter C earnings and profits must have been distributed.

(e) *Reduction in pass-thru for tax imposed on excess net passive income*. See section 1366(f)(3) for a special rule reducing each item of the corporation's passive investment income for purposes of section 1366(a) if a tax is imposed on the corporation under section 1375.

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

Example 1. Assume Corporation M, an S corporation, has for its taxable year total gross receipts of $200,000, passive investment income of $100,000, $60,000 of which is interest income, and expenses directly connected with the production of such interest income in the amount of $10,000. Assume also that at the end of the taxable year Corporation M has subchapter C earnings and profits. Since more than 25 percent of the Corporation M's total gross receipts are passive investment income, and since Corporation M has subchapter C earnings and profits at the end of the taxable year, Corporation M will be subject to the tax imposed by section 1375. The amount of excess net passive investment income is $45,000 ($90,000 × (50,000 / 100,000)). Assume that the other $40,000 of passive investment income is attributable to net capital gain and that there are no expenses directly connected with such gain. Under these facts, $20,000 of the excess net passive income is attributable to the net capital gain ($45,000 × ($40,000 / $90,000)). Accordingly, the amount of gain taken into account under section 1374(b)(1) and the taxable income of Corporation M under section 1374(b)(2) shall be reduced by $20,000.

Example 2. Assume an S corporation with subchapter C earnings and profits has tax-exempt income of $400, its only passive income, gross receipts of $1,000 and taxable income of $250 and there are no expenses associated with the tax-exempt income. The corporation's excess net income for the taxable year would total $150 (400 × ((400 − 250 / 400)). This amount is subject to the tax imposed by section 1375, notwithstanding that such amount is otherwise tax-exempt income.

[T.D. 8104, 51 FR 34203, Sept. 26, 1986; 52 FR 9162, Mar. 23, 1987. Redesignated and amended by T.D. 8419, 57 FR 22653, May 29, 1992]

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§ 1.1377–3 Effective date.

[T.D. 8696, 61 FR 67455, Dec. 23, 1996, as amended by T.D. 8994, 67 FR 34401, May 14, 2002]

§ 1.1377–1 Pro rata share.

(a) *Computation of pro rata shares*—(1) *In general.* For purposes of subchapter S of chapter 1 of the Internal Revenue Code and this section, each shareholder's pro rata share of any S corporation item described in section 1366(a) for any taxable year is the sum of the amounts determined with respect to the shareholder by assigning an equal portion of the item to each day of the S corporation's taxable year, and then dividing that portion pro rata among the shares outstanding on that day. See paragraph (b) of this section for rules pertaining to the computation of each shareholder's pro rata share when an election is made under section 1377(a)(2) to treat the taxable year of an S corporation as if it consisted of two taxable years in the case of a termination of a shareholder's entire interest in the corporation. See § 1.460–4(k)(3)(iv)(D) for rules relating to the computation of the shareholders' pro rata share of S corporation's income or loss from a contract accounted for under a long-term contract method of accounting.

(2) *Special rules*—(i) *Days on which stock has not been issued.* Solely for purposes of determining a shareholder's pro rata share of an item for a taxable year under section 1377(a) and this section, the beneficial owners of the corporation are treated as the shareholders of the corporation for any day on which the corporation has not issued any stock.

(ii) *Determining shareholder for day of stock disposition.* A shareholder who disposes of stock in an S corporation is treated as the shareholder for the day of the disposition. A shareholder who dies is treated as the shareholder for the day of the shareholder's death.

(iii) Shareholder trust conversions. If, during the taxable year of an S corporation, a trust that is an eligible shareholder of the S corporation converts from a trust described in section 1361(c)(2)(A)(i), (ii), (iii), or (v) for the first part of the year to a trust described in a different subpart of section 1361(c)(2)(A)(i), (ii), or (v) for the remainder of the year, the trust's share of the S corporation items is allocated between the two types of trusts. The first day that a qualified subchapter S trust (QSST) or an electing small business trust (ESBT) is treated as an S corporation shareholder is the effective date of the QSST or ESBT election. Upon the conversion, the trust is not treated as terminating its entire interest in the S corporation for purposes of paragraph (b) of this section, unless the trust was a trust described in section 1361(c)(2)(A)(ii) or (iii) before the conversion.

(b) *Election to terminate year*—(1) *In general.* If a shareholder's entire interest in an S corporation is terminated during the S corporation's taxable year and the corporation and all affected shareholders agree, the S corporation may elect under section 1377(a)(2) and this paragraph (b) (terminating election) to apply paragraph (a) of this section to the affected shareholders as if the corporation's taxable year consisted of two separate taxable years, the first of which ends at the close of the day on which the shareholder's entire interest in the S corporation is terminated. If the event resulting in the termination of the shareholder's entire interest also constitutes a qualifying disposition as described in § 1.1368–1(g)(2)(i), the election under § 1.1368–1(g)(2) cannot be made. An S corporation may not make a terminating election if the cessation of a shareholder's interest occurs in a transaction that results in a termination under section 1362(d)(2) of the corporation's election to be an S corporation. (See section 1362(e)(3) for an election to have items assigned to each short taxable year under normal tax accounting rules in the case of a termination of a corporation's election to be

an S corporation.) A terminating election is irrevocable and is effective only for the terminating event for which it is made.

(2) *Affected shareholders*. For purposes of the terminating election under section 1377(a)(2) and paragraph (b) of this section, the term *affected shareholders* means the shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the taxable year. If such shareholder has transferred shares to the corporation, the term *affected shareholders* includes all persons who are shareholders during the taxable year.

(3) *Effect of the terminating election*—(i) *In general*. An S corporation that makes a terminating election for a taxable year must treat the taxable year as separate taxable years for all affected shareholders for purposes of allocating items of income (including tax-exempt income), loss, deduction, and credit; making adjustments to the accumulated adjustments account, earnings and profits, and basis; and determining the tax effect of a distribution. An S corporation that makes a terminating election must assign items of income (including tax-exempt income), loss, deduction, and credit to each deemed separate taxable year using its normal method of accounting as determined under section 446(a).

(ii) *Section 163(j)*. If a terminating election is made to treat the S corporation's taxable year as consisting of separate taxable years, for purposes of section 163(j), a separate limitation (as defined in §1.163(j)–1(b)(36)) will apply to each separate taxable year. Any items necessary to determine the amount of business interest expense (as defined in §1.163(j)–1(b)(3)) that are deducted in each separate taxable year must be allocated between the separate taxable years in accordance with an allocation methodology provided in this section.

(iii) *Due date of S corporation return*. A terminating election does not affect the due date of the S corporation's return required to be filed under section 6037(a) for a taxable year (determined without regard to a terminating election).

(iv) *Taxable year of inclusion by shareholder*. A terminating election does not affect the taxable year in which an affected shareholder must take into account the affected shareholder's pro rata share of the S corporation's items of income, loss, deduction, and credit.

(v) *S corporation that is a partner in a partnership*. A terminating election by an S corporation that is a partner in a partnership is treated as a sale or exchange of the corporation's entire interest in the partnership for purposes of section 706(c) (relating to closing the partnership taxable year), if the taxable year of the partnership ends after the shareholder's interest is terminated and within the taxable year of the S corporation (determined without regard to any terminating election) for which the terminating election is made.

(4) *Determination of whether an S shareholder's entire interest has terminated*. For purposes of the terminating election under section 1377(a)(2) and paragraph (b) of this section, a shareholder's entire interest in an S corporation is terminated on the occurrence of any event through which a shareholder's entire stock ownership in the S corporation ceases, including a sale, exchange, or other disposition of all of the stock held by the shareholder; a gift under section 102(a) of all the shareholder's stock; a spousal transfer under section 1041(a) of all the shareholder's stock; a redemption, as defined in section 317(b), of all the shareholder's stock, regardless of the tax treatment of the redemption under section 302; and the death of the shareholder. A shareholder's entire interest in an S corporation is not terminated if the shareholder retains ownership of any stock (including an interest treated as stock under §1.1361–1(l)) that would result in the shareholder continuing to be considered a shareholder of the corporation for purposes of section 1362(a)(2). Thus, in determining whether a shareholder's entire interest in an S corporation has been terminated, any interest held by the shareholder as a creditor, employee, director, or in any other non-shareholder capacity is disregarded.

(5) *Time and manner of making a terminating election*—(i) *In general*. An S corporation makes a terminating election by attaching a statement to its timely

filed original or amended return required to be filed under section 6037(a) (that is, a Form 1120S) for the taxable year during which a shareholder's entire interest is terminated. A single election statement may be filed by the S corporation for all terminating elections for the taxable year. The election statement must include—

(A) A declaration by the S corporation that it is electing under section 1377(a)(2) and this paragraph (b) to treat the taxable year as if it consisted of two separate taxable years;

(B) Information setting forth when and how the shareholder's entire interest was terminated (for example, a sale or gift);

(C) The signature on behalf of the S corporation of an authorized officer of the corporation under penalties of perjury, except that for taxable years beginning after December 31, 2002, the election statement described in § 1.1377–1(b)(5)(i) of this section shall be verified, and the requirement of this paragraph (b)(5)(i)(C) is satisfied, by the signature on the Form 1120S filed by the S corporation.

(D) A statement by the corporation that the corporation and each affected shareholder consent to the S corporation making the terminating election.

(ii) *Affected shareholders required to consent.* For purposes of paragraph (b)(5)(i)(D) of this section, a shareholder of the S corporation for the taxable year is a shareholder as described in section 1362(a)(2). For example, the person who under § 1.1362–6(b)(2) must consent to a corporation's S election in certain special cases is the person who must consent to the terminating election. In addition, an executor or administrator of the estate of a deceased affected shareholder may consent to the terminating election on behalf of the deceased affected shareholder.

(iii) *More than one terminating election.* A shareholder whose entire interest in an S corporation is terminated in an event for which a terminating election was made is not required to consent to a terminating election made with respect to a subsequent termination within the same taxable year unless the shareholder is an affected shareholder with respect to the subsequent termination.

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

Example 1. Shareholder's pro rata share in the case of a partial disposition of stock. (i) On January 6, 1997, X incorporates as a calendar year corporation, issues 100 shares of common stock to each of A and B, and files an election to be an S corporation for its 1997 taxable year. On July 24, 1997, B sells 50 shares of X stock to C. Thus, in 1997, A owned 50 percent of the outstanding shares of X on each day of X's 1997 taxable year, B owned 50 percent on each day from January 6, 1997, to July 24, 1997 (200 days), and 25 percent from July 25, 1997, to December 31, 1997 (160 days), and C owned 25 percent from July 25, 1997, to December 31, 1997 (160 days).

(ii) Because B's entire interest in X is not terminated when B sells 50 shares to C on July 24, 1997, X cannot make a terminating election under section 1377(a)(2) and paragraph (b) of this section for B's sale of 50 shares to C. Although B's sale of 50 shares to C is a qualifying disposition under § 1.1368–1(g)(2)(i), X does not make an election to terminate its taxable year under § 1.1368–1(g)(2). During its 1997 taxable year, X has nonseparately computed income of $720,000.

(iii) For each day in X's 1997 taxable year, A's daily pro rata share of X's nonseparately computed income is $1,000 ($720,000/360 days × 50%). Thus, A's pro rata share of X's nonseparately computed income for 1997 is $360,000 ($1,000 × 360 days). B's daily pro rata share of X's nonseparately computed income is $1,000 ($720,000/360 × 50%) for the first 200 days of X's 1997 taxable year, and $500 ($720,000/360 × 25%) for the following 160 days in 1997. Thus, B's pro rata share of X's nonseparately computed income for 1997 is $280,000 (($1,000 × 200 days) + ($500 × 160 days)). C's daily pro rata share of X's nonseparately computed income is $500 ($720,000/360 × 25%) for 160 days in 1997. Thus, C's pro rata share of X's nonseparately computed income for 1997 is $80,000 ($500 × 160 days).

Example 2. Shareholder's pro rata share when an S corporation makes a terminating election under section 1377(a)(2). (i) On January 6, 1997, X incorporates as a calendar year corporation, issues 100 shares of common stock to each of A and B, and files an election to be an S corporation for its 1997 taxable year. On July 24, 1997, B sells B's entire 100 shares of X stock to C. With the consent of B and C, X makes an election under section 1377(a)(2) and paragraph (b) of this section for the termination of B's entire interest arising from B's sale of 100 shares to C. As a result of the election, the pro rata shares of B and C are determined as if X's taxable year consisted of two separate taxable years, the first of which ends on July 24, 1997, the date B's entire interest in X terminates. Because A is

not an affected shareholder as defined by section 1377(a)(2)(B) and paragraph (b)(2) of this section, the treatment as separate taxable years does not apply to A.

(ii) During its 1997 taxable year, X has nonseparately computed income of $720,000. Under X's normal method of accounting, $200,000 of the $720,000 of nonseparately computed income is allocable to the period of January 6, 1997, through July 24, 1997 (the first deemed taxable year), and the remaining $520,000 is allocable to the period of July 25, 1997, through December 31, 1997 (the second deemed taxable year).

(iii) B's pro rata share of the $200,000 of nonseparately computed income for the first deemed taxable year is determined by assigning the $200,000 of nonseparately computed income to each day of the first deemed taxable year ($200,000/200 days = $1,000 per day). Because B held 50% of X's authorized and issued shares on each day of the first deemed taxable year, B's daily pro rata share for each day of the first deemed taxable year is $500 ($1,000 per day × 50%). Thus, B's pro rata share of the $200,000 of nonseparately computed income for the first deemed taxable year is $100,000 ($500 per day × 200 days). B must report this amount for B's taxable year with or within which X's full taxable year ends (December 31, 1997).

(iv) C's pro rata share of the $520,000 of nonseparately computed income for the second deemed taxable year is determined by assigning the $520,000 of nonseparately computed income to each day of the second deemed taxable year ($520,000/160 days = $3,250 per day). Because C held 50% of X's authorized and issued shares on each day of the second deemed taxable year, C's daily pro rata shares for each day of the second deemed taxable year is $1,625 ($3,250 per day × 50%). Therefore, C's pro rata share of the $520,000 of nonseparately computed income is $260,000 ($1,625 per day × 160 days). C must report this amount for C's taxable year with or within which X's full taxable year ends (December 31, 1997).

Example 3. Effect of conversion of a qualified subchapter S trust (QSST) to an electing small business trust (ESBT). (i) On January 1, 2003, Trust receives stock of S corporation. Trust's current income beneficiary makes a timely QSST election under section 1361(d)(2), effective January 1, 2003. Subsequently, the trustee and current income beneficiary of Trust elect, pursuant to § 1.1361–1(j)(12), to terminate the QSST election and convert to an ESBT, effective July 1, 2004. The taxable year of S corporation is the calendar year. In 2004, Trust's pro rata share of S corporation's nonseparately computed income is $100,000.

(ii) For purposes of computing the income allocable to the QSST and to the ESBT, Trust is treated as a QSST through June 30, 2004, and Trust is treated as an ESBT beginning July 1, 2004. Pursuant to section 1377(a)(1), the pro rata share of S corporation income allocated to the QSST is $49,727 ($100,000 × 182 days/366 days), and the pro rata share of S corporation income allocated to the ESBT is $50,273 ($100,000 × 184 days/366 days).

[T.D. 8696, 61 FR 67456, Dec. 23, 1996, as amended by T.D. 8994, 67 FR 34401, May 14, 2002; T.D. 9100, 68 FR 70706, Dec. 19, 2003; T.D. 9137, 69 FR 42559, July 16, 2004; T.D. 9300, 71 FR 71043, Dec. 8, 2006; T.D. 9905, 85 FR 56843, Sept. 14, 2020]

§ 1.1377–2 Post-termination transition period.

(a) *In general.* For purposes of subchapter S of chapter 1 of the Internal Revenue Code (Code) and this section, the term *post-termination transition period* means—

(1) The period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of—

(i) The day which is 1 year after such last day; or

(ii) The due date for filing the return for the last taxable year as an S corporation (including extensions);

(2) The 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer which follows the termination of the corporation's election and which adjusts a subchapter S item of income, loss, or deduction of the corporation arising during the S period (as defined in section 1368(e)(2)); and

(3) The 120-day period beginning on the date of a determination that the corporation's election under section 1362(a) had terminated for a previous taxable year.

(b) *Special rules for post-termination transition period.* Pursuant to section 1377(b)(1) and paragraph (a)(1) of this section, a post-termination transition period arises the day after the last day that an S corporation was in existence if a C corporation acquires the assets of the S corporation in a transaction to which section 381(a)(2) applies. However, if an S corporation acquires the assets of another S corporation in a transaction to which section 381(a)(2) applies, a post-termination transition period does not arise. (See § 1.1368–2(d)(2) for the treatment of the acquisition of the assets of an S corporation

by another S corporation in a transaction to which section 381(a)(2) applies.)

(c) *Determination defined.* For purposes of section 1377(b)(1) and paragraph (a) of this section, the term *determination* means—

(1) A determination as defined in section 1313(a);

(2) A written agreement between the corporation and the Commissioner (including a statement acknowledging that the corporation's election to be an S corporation terminated under section 1362(d)) that the corporation failed to qualify as an S corporation;

(3) For a corporation subject to the audit and assessment provisions of subchapter C of chapter 63 of subtitle A of the Code, the expiration of the period specified in section 6226 for filing a petition for readjustment of a final S corporation administrative adjustment finding that the corporation failed to qualify as an S corporation, provided that no petition was timely filed before the expiration of the period; and

(4) For a corporation not subject to the audit and assessment provisions of subchapter C of chapter 63 of subtitle A of the Code, the expiration of the period for filing a petition under section 6213 for the shareholder's taxable year for which the Commissioner has made a finding that the corporation failed to qualify as an S corporation, provided that no petition was timely filed before the expiration of the period.

(d) *Date a determination becomes effective*—(1) *Determination under section 1313(a).* A determination under paragraph (c)(1) of this section becomes effective on the date prescribed in section 1313 and the regulations thereunder.

(2) *Written agreement.* A determination under paragraph (c)(2) of this section becomes effective when it is signed by the district director having jurisdiction over the corporation (or by another Service official to whom authority to sign the agreement is delegated) and by an officer of the corporation authorized to sign on its behalf. Neither the request for a written agreement nor the terms of the written agreement suspend the running of any statute of limitations.

(3) *Implied agreement.* A determination under paragraph (c) (3) or (4) of this section becomes effective on the day after the date of expiration of the period specified under section 6226 or 6213, respectively.

[T.D. 8696, 61 FR 67457, Dec. 23, 1996, as amended by T.D. 9914, 85 FR 66484, Oct. 20, 2020]

§ 1.1377–3 Applicability dates.

(a) *In general.* Except as otherwise provided in this section, §§ 1.1377–1 and 1.1377–2 apply to taxable years of an S corporation beginning after December 31, 1996.

(b) *Certain conversions.* Section 1.1377–1(a)(2)(iii) and (c)(3) (*Example 3)* are applicable for taxable years beginning on and after May 14, 2002.

(c) *Special treatment of distributions of money during post-termination transition period*—(1) *In general.* Except as provided in paragraph (c)(2) of this section, § 1.1377–2(b) applies to taxable years beginning after October 20, 2020. For taxable years beginning on or before October 20, 2020, see § 1.1377–2(b) as contained in 26 CFR part 1, revised April 1, 2020.

(2) *Taxable years beginning on or before October 20, 2020.* A corporation may choose to apply § 1.1377–2(b) to taxable years beginning on or before October 20, 2020 and with respect to which the period described in section 6501(a) has not expired. If a corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently, and the corporation must adopt §§ 1.481–5, 1.1371–1, 1.1371–2, if an ETSC, and 1.1377–2(b) in their entity and continue to apply those rules in their entirety for the corporation's subsequent taxable years.

[T.D. 9914, 85 FR 66484, Oct. 20, 2020]

§ 1.1378–1 Taxable year of S corporation.

(a) *In general.* The taxable year of an S corporation must be a permitted year. A permitted year is the required taxable year (*i.e.*, a taxable year ending on December 31), a taxable year elected under section 444, a 52–53-week taxable year ending with reference to the required taxable year or a taxable year

elected under section 444, or any other taxable year for which the corporation establishes a business purpose to the satisfaction of the Commissioner under section 442.

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

(c) *Change in taxable year*—(1) *Approval required*. An S corporation or electing S corporation that wants to change its taxable year must obtain the approval of the Commissioner under section 442 or make an election under section 444. However, an S corporation or electing S corporation may obtain automatic approval for certain changes, including a change to its required taxable year, pursuant to administrative procedures published by the Commissioner.

(2) *Short period tax return*. An S corporation or electing S corporation that changes its taxable year must make its return for a short period in accordance with section 443, but must not annualize the corporation's taxable income.

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

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

(2) *Special rules for electing S corporations*. An electing S corporation that wants to adopt, change to, or retain a taxable year other than its required taxable year must request approval of the Commissioner on Form 2553, ''Election by a Small Business Corporation,'' when the election to be an S corporation is filed pursuant to section 1362(b) and §1.1362–6. See §1.1362–6(a)(2)(i) for the manner of making an election to be an S corporation. If such corporation receives permission to adopt, change to, or retain a taxable year other than its required taxable year, the election to be an S corporation will be effective. Denial of the request renders the election ineffective unless the corporation agrees that, in the event the request to adopt, change to, or retain a taxable year other than its required taxable year is denied, it will adopt, change to, or retain its required taxable year or, if applicable, make an election under section 444.

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

[T.D. 8996, 67 FR 35024, May 17, 2002]

SECTION 1374 BEFORE THE TAX REFORM ACT OF 1986

§ 1.1374–1A Tax imposed on certain capital gains.

(a) *General rule*. Except as otherwise provided in paragraph (c) of this section, if for a taxable year beginning after 1982 of an S corporation—

(1) The net capital gain of such corporation exceeds $25,000, and

(2) The net capital gain of such corporation exceeds 50 percent of its taxable income (as defined in paragraph (d) of this section) for such year, and

(3) The taxable income of such corporation (as defined in paragraph (d) of this section) for such year exceeds $25,000,

section 1374 imposes a tax (computed under paragraph (b) of this section) on the income of such corporation. The tax is imposed on the S corporation and not on the shareholders.

(b) *Amount of tax*. The amount of tax shall be the lower of—

(1) An amount equal to the tax, determined as provided in section 1201(a)(2), on the amount by which the net capital gain of the corporation for the taxable year exceeds $25,000, or

(2) An amount equal to the tax which would be imposed by section 11 on the taxable income of the corporation (as defined in paragraph (d) of this section) for the taxable year were it not an S corporation.

No credit shall be allowable under part IV of subchapter A of chapter 1 of the Internal Revenue Code of 1954 (other than under section 34) against the tax imposed by section 1374(a) and this section. See section 1375(c)(2) and § 1.1375–1(c)(2) for a special rule that reduces the amount of the net capital gain of the corporation for purposes of this paragraph (b) in cases where a net capital gain is taxed as excess net passive income under section 1375. See section 1374(c)(3) and paragraph (c)(1)(ii) of this section for a special rule that limits the amount of tax on property with a substituted basis in certain cases.

(c) *Exceptions to taxation*—(1) *New corporations and corporations with election in effect for 3 immediately preceding years*—(i) *In general.* If an S corporation would be subject to the tax imposed by section 1374 for a taxable year pursuant to paragraph (a) of this section, the corporation shall, nevertheless, not be subject to such tax for such year, if:

(A) The election under section 1362(a) which is in effect with respect to such corporation for such year has been in effect for the corporation's three immediately preceding taxable years, or

(B) An election under section 1362(a) has been in effect with respect to such corporation for each of its taxable years for which it has been in existence, unless there is a net capital gain for the taxable year which is attributable to property with a substituted basis within the meaning of paragraph (c)(1)(iii) of this section.

(ii) *Amount of tax on net capital gain attributable to property with a substituted basis.* If for a taxable year of an S corporation either paragraph (c)(1)(i) (A) or (B) of this section is satisfied, but the S corporation has a net capital gain for such taxable year which is attributable to property with a substituted basis (within the meaning of paragraph (c)(1)(iii) of this section), then paragraph (a) of this section shall apply for the taxable year, but the amount of tax determined under paragraph (b) of this section shall not exceed a tax, determined as provided in section 1201 (a), on the net capital gain attributable to property with a substituted basis.

(iii) *Property with substituted basis.* For purposes of this section, the term *property with a substituted basis* means:

(A) Property acquired by a corporation (*the acquiring corporation*) during the period beginning 36 months before the first day of the acquiring corporation's taxable year and ending on the last day of such year;

(B) The basis of such property in the hands of the acquiring corporation is determined in whole or in part by reference to the basis of any property in the hands of another corporation; and

(C) Such other corporation was not an S corporation throughout the period beginning the later of:

(*1*) 36 months before the first day of the acquiring corporation's taxable year, or

(*2*) The time such other corporation came into existence,

and ending on the date such other corporation transferred the property, the basis of which is used to determine, in whole or in part, the basis of the property in the hands of the acquiring corporation. An S corporation and any predecessor corporation shall not be treated as one corporation for purposes of this paragraph (c) (1).

(iv) *Existence of a corporation.* For purposes of this section, a corporation shall not be considered to be in existence for any month which precedes the first month in which such corporation has shareholders or acquires assets or begins business, whichever is first to occur.

(v) *References to prior law included.* For purposes of this paragraph (c), the term *S corporation* shall include an electing small business corporation under prior subchapter S law, and the term *election under section 1362 (a)* shall include an election under section 1372 of prior subchapter S law.

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

Example 1. M Corporation was organized and began business in 1977. M subsequently made an election under section 1362 (a) which was effective for its 1984 taxable year. If such election does not terminate under section 1362 for its taxable years 1984, 1985, and 1986, M is not subject to the tax imposed by section 1374 for its taxable year 1987, or for any subsequent year for which such election remains in effect, unless it has, for any such year, an excess of net long-term capital gain over net short-term capital loss attributable to property with a substituted basis. If there is such an excess for any such year, and the requirements of paragraph (a) of this section are met, M will be subject to the tax for such year. If there is no such excess for any year after 1986, M will not be subject to the tax for any such year even though the requirements of paragraph (a) of this section are met.

Example 2. N corporation was organized in 1983, and was an S corporation for its first taxable year, N is not subject to the tax imposed by section 1374 for 1983, or for any subsequent year for which its orginal election under section 1362 (a) has not terminated under section 1362(d), unless, for any such year, it has an excess of net long-term capital gain over net short-term capital loss attributable to property with a substituted basis and the requirements of paragraph (a) of this section are met.

(2) *Treatment of certain gains of options and commodities dealers*—(i) *Exclusion of certain capital gains.* For purposes of this section, the net capital gain of any options dealer or commodities dealer shall be determined by not taking into account any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section 1256 contracts) from any section 1256 contract or property related to such a contract.

(ii) *Definitions.* For purposes of this paragraph (c)(2)—

(A) *Options dealer.* The term *options dealer* has the meaning given to such term by section 1256(g)(8).

(B) *Commodities dealer.* The term *commodities dealer* means a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission.

(C) *Section 1256 contracts.* The term *section 1256 contracts* has the meaning given to such term by section 1256(b).

(iii) *Effective dates*—(A) *In general.* Except as otherwise provided in this paragraph (c)(2)(iii), this paragraph (c)(2) shall apply to positions established after July 18, 1984, in taxable years ending after such date.

(B) *Special rule for options on regulated futures contracts.* In the case of any option with respect to a regulated futures contract (within the meaning of section 1256), this paragraph (c)(2) shall apply to positions established after October 31, 1983, in taxable years ending after such date.

(C) *Elections with respect to property held on or before July 18, 1984.* See §§ 1.1256 (h)–1T and 1.1256(h)–2T for rules concerning an election to have this paragraph (c)(2) apply to certain property held on or before July 18, 1984.

(d) *Determination of taxable income*—(1) *General rule.* For purposes of this section, taxable income of the corporation shall be determined under section 63(a) as if the corporation were a C corporation rather than an S corporation, except that the following deductions shall not apply in the computation—

(i) The deduction allowed by section 172 (relating to net operating loss deduction), and

(ii) The deductions allowed by part VIII of subchapter B (other than the deduction allowed by section 248, relating to organization expenditures).

For any taxable year in which a tax under this section is imposed on an S corporation, the S corporation shall attach a Form 1120 completed in accordance with this paragraph (d) and the instructions to Form 1120S to its tax return filed for such taxable year.

(2) *Special rule for net capital gains taxed as excess net passive income under section 1375.* See section 1375 (c) (2) and § 1.1375–1(c)(2) for a special rule that reduces the taxable income of the corporation for purposes of section 1374(b)(2) and § 1.1374–1(b)(2) in cases where a net capital gain is taxed as excess net passive income under section 1375.

(e) *Reduction in pass-thru for tax imposed on capital gain.* See section 1366(f)(2) for a special rule reducing the S corporation's long-term capital gains and the corporation's gain from sales or exchanges of property described in section 1231 for purposes of section 1366(a) by an amount of tax imposed under section 1374 and this section.

(f) *Examples*. The following examples illustrate the principles of this section and assume that a tax will not be imposed under section 1375:

Example 1. Corporation M is an S corporation for its taxable year beginning January 1, 1983. For 1983, M has an excess of net long-term capital gain over net short-term capital loss in the amount of $30,000. However, its taxable income for the year is only $20,000 as a result of other deductions in excess of other income. Thus, although the excess of the net long-term capital gain over the net short-term capital loss exceeds $25,000 and also exceeds 50 percent of taxable income, M is not subject to the tax imposed by section 1374 for 1983 because its taxable income does not exceed $25,000.

Example 2. Corporation N is an S Corporation for its 1983 taxable year. For 1983, N has an excess of net long-term capital gain over net short-term capital loss in the amount of $30,000, and taxable income of $65,000. Thus, although N's net capital gain ($30,000) exceeds $25,000, it does not exceed 50 percent of the corporation's taxable income for the year (50 percent of $65,000, or $32,500), and therefore N is not subject to the tax imposed by section 1374 for such year.

Example 3. Assume that Corporation O, an S corporation, is subject to the tax imposed by section 1374 for its taxable year 1983. For 1983, O has an excess of net long-term capital gain over net short-term capital loss in the amount of $73,000, and taxable income within the meaning of section 1374, which includes capital gains and losses, of $100,000. The amount of tax computed under paragraph (b)(1) of this section is 28 percent of $48.00 ($73,000—$25,000), or $13,440. Since this is lower than the amount computed under paragraph (b)(2) of this section, which is $25,750 ($3,750 + $4,500 + $7,500 + $10,000), $13,440 is the amount of tax imposed by section 1374.

Example 4. Assume that in example (3) the taxable income of O for 1983 is $35,000. This results from an excess of deductions over income with respect to items which were not included in determining the excess of the net long-term capital gain over the net short-term capital loss. In such case, the amount of tax, computed under paragraph (b)(2) of this section, is $5,550. Since this is lower than the amount computed under paragraph (b)(1) of this section, $5,550 is the amount of tax imposed by section 1374.

Example 5. Corporation P, an S corporation, for its taxable year 1983 has an excess of net long-term capital gain over net short-term capital loss in the amount of $65,000 and has taxable income of $80,000. P's election under section 1362 has been in effect for its three immediately preceding taxable years, but P, nevertheless, is subject to the tax imposed by section 1374 for 1983 since it has an excess of net long-term capital gain over net short-term capital loss (in the amount of $20,000) attributable to property with a substituted basis. The tax computed under paragraph (b)(1) of this section, $11,200 (28 percent of $40,000 ($65,000 − $25,000)), is less than the tax computed under paragraph (b)(2) of this section, $17,750. However, under the limitation provided in paragraph (c) of this section which is applicable in this factual situation, the tax imposed by section 1374 for 1983 may not exceed $5,600 (28 percent of $20,000, the excess of net long-term capital gain over net short-term capital loss attributable to property with a substituted basis).

[T.D. 8104, 51 FR 34201, Sept. 26, 1986; 52 FR 9162, Mar. 23, 1987. Redesignated and amended by T.D. 8419, 57 FR 22653, May 29, 1992. Further redesignated by T.D. 8579, 59 FR 66462, Dec. 27, 1994]

COOPERATIVES AND THEIR PATRONS

Tax Treatment of Cooperatives

§ 1.1381–1 Organizations to which part applies.

(a) *In general*. Except as provided in paragraph (b) of this section, part I, subchapter T, chapter 1 of the Code, applies to any corporation operating on a cooperative basis and allocating amounts to patrons on the basis of the business done with or for such patrons.

(b) *Exceptions*. Part I of such subchapter T does not apply to:

(1) Any organization which is exempt from income taxes under chapter 1 of the Code (other than an exempt farmers' cooperative described in section 521);

(2) Any organization which is subject to the provisions of part II (section 591 and following), subchapter H, chapter 1 of the Code (relating to mutual savings banks, etc.);

(3) Any organization which is subject to the provisions of subchapter L (section 801 and following), chapter 1 of the Code (relating to insurance companies); or

(4) Any organization which is engaged in generating, transmitting, or otherwise furnishing electric energy, or which provides telephone service, to persons in rural areas. The terms *rural areas* and *telephone service* shall have

the meaning assigned to them in section 5 of the Rural Electrification Act of 1936, as amended (7 U.S.C. 924).

[T.D. 6643, 28 FR 3153, Apr. 2, 1963]

§ 1.1381–2 Tax on certain farmers' cooperatives.

(a) *In general.* (1) For taxable years beginning after December 31, 1962, farmers', fruit growers', or like associations, organized and operated in compliance with the requirements of section 521 and § 1.521–1, shall be subject to the taxes imposed by section 11 or section 1201. Although such associations are subject to both normal tax and surtax, as in the case of corporations generally, certain special deductions are provided for them in section 1382(c) and § 1.1382–3. For the purpose of any law which refers to organizations exempt from income taxes such an association shall, however, be considered as an organization exempt under section 501. Thus, the provisions of section 243, providing a credit for dividends received from a domestic corporation subject to taxation, are not applicable to dividends received from a cooperative association organized and operated in compliance with the requirements of section 521 and § 1.521–1. The provisions of section 1501, relating to consolidated returns, are likewise not applicable.

(2) Rules governing the manner in which amounts paid as patronage dividends are allowable as deductions in computing the taxable income of such an association are set forth in section 1382(b) and § 1.1382–2. For the tax treatment, as to patrons, of amounts received during the taxable year as patronage dividends, see section 1385 and the regulations thereunder.

(b) *Cross references.* For tax treatment of exempt cooperative associations for taxable years beginning before January 1, 1963, or for taxable years beginning after December 31, 1962, with respect to payments attributable to patronage occurring during taxable years beginning before January 1, 1963, see section 522 and the regulations thereunder. For requirements of annual returns by such associations, see sections 6012 and 6072(d) and paragraph (f) of § 1.6012–2.

[T.D. 6643, 28 FR 3153, Apr. 2, 1963]

§ 1.1382–1 Taxable income of cooperatives; gross income.

(a) *Introduction.* Section 1382(b) provides that the amount of certain patronage dividends (and amounts paid in redemption of nonqualified written notices of allocation) shall not be taken into account by a cooperative organization in determining its taxable income. Such section also provides that, for purposes of the Internal Revenue Code, an amount not taken into account is to be treated in the same manner as an item of gross income and as a deduction therefrom. Therefore, such an amount is treated as a deduction for purposes of applying the Internal Revenue Code and the regulations thereunder and, for simplicity, is referred to as a deduction in the regulations under such Code. However, this should not be regarded as a determination of the character of the amount for other purposes.

(b) *Computation of gross income.* Any cooperative organization to which part I, subchapter T, chapter 1 of the Code, applies shall not, for any purpose under the Code, exclude from its gross income (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) the amount of any allocation or distribution to a patron out of the net earnings of such organization with respect to patronage occurring during a taxable year beginning after December 31, 1962. See, however, section 1382(b) and § 1.1382–2 for deductions for certain amounts paid to patrons out of net earnings.

[T.D. 6643, 28 FR 3154, Apr. 2, 1963]

§ 1.1382–2 Taxable income of cooperatives; treatment of patronage dividends.

(a) *In general.* (1) In determining the taxable income of any cooperative organization to which part I, subchapter T, chapter 1 of the Code, applies, there shall be allowed as deductions from gross income, in addition to the other deductions allowable under chapter 1 of the Code, the deductions with respect to patronage dividends provided in section 1382(b) and paragraphs (b) and (c) of this section.

(2) For the definition of terms used in this section see section 1388 and

§ 1.1388–1; to determine the payment period for a taxable year, see section 1382(d) and § 1.1382–4.

(b) *Deduction for patronage dividends*—(1) *In general*. In the case of a taxable year beginning after December 31, 1962, there is allowed as a deduction from the gross income of any cooperative organization to which part I of subchapter T applies, amounts paid to patrons during the payment period for the taxable year as patronage dividends with respect to patronage occurring during such taxable year, but only to the extent that such amounts are paid in money, qualified written notices of allocation, or other property (other than non qualified written notices of allocation). See section 1382 (e) and (f) and §§ 1.1382–5 and 1.1382–6 for special rules relating to the time when patronage is deemed to occur where products are marketed under a pooling arrangement or where earnings are includible in the gross income of the cooperative organization for a taxable year after the year in which the patronage occurred. For purposes of this paragraph, a written notice of allocation is considered paid when it is issued to the patron. A patronage dividend shall be treated as paid in money during the payment period for the taxable year to the extent it is paid by a qualified check which is issued during the payment period for such taxable year and endorsed and cashed on or before the ninetieth day after the close of such payment period. In determining the amount paid which is allowable as a deduction under this paragraph, property (other than written notices of allocation) shall be taken into account at its fair market value when paid, and a qualified written notice of allocation shall be taken into account at its stated dollar amount.

(2) *Special rule for certain taxable years*. No deduction is allowed under this section for amounts paid during taxable years beginning before January 1, 1963, or for amounts paid during taxable years beginning after December 31, 1962, with respect to patronage occurring during taxable years beginning before January 1, 1963. With respect to such amounts, the Internal Revenue Code of 1954 (including section 522 and the regulations thereunder) shall be applicable without regard to subchapter T.

(c) *Deduction for amounts paid in redemption of certain nonqualified written notices of allocation*. In the case of a taxable year beginning after December 31, 1962, there is allowed as a deduction from the gross income of a cooperative organization to which part I of subchapter T applies, amounts paid by such organization during the payment period for such taxable year in redemption of a nonqualified written notice of allocation which was previously paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred, but only to the extent such amounts (1) are paid in money or other property (other than written notices of allocation) and (2) do not exceed the stated dollar amount of such written notice of allocation. No deduction shall be allowed under this paragraph, however, for amounts paid in redemption of nonqualified written notices of allocation which were paid with respect to patronage occurring during a taxable year beginning before January 1, 1963. For purposes of this paragraph, if an amount is paid within the payment period for two or more taxable years, it will be allowable as a deduction only for the earliest of such taxable years. Thus, if a cooperative which reports its income on a calendar year basis pays an amount in redemption of a nonqualified written notice of allocation on January 15, 1966, it will be allowed a deduction for such amount only for its 1965 taxable year. In determining the amount paid which is allowable as a deduction under this paragraph, property (other than written notices of allocation) shall be taken into account at its fair market value when paid. Amounts paid in redemption of a nonqualified written notice of allocation in excess of its stated dollar amount shall be treated under the applicable provisions of the Code. For example, if such excess is in the nature of interest, its deductibility will be governed by section 163 and the regulations thereunder.

[T.D. 6643, 28 FR 3154, Apr. 2, 1963]

§ 1.1382–3 Taxable income of cooperatives; special deductions for exempt farmers' cooperatives.

(a) *In general.* (1) Section 1382(c) provides that in determining the taxable income of a farmers', fruit growers', or like association, described in section 1381(a)(1) and organized and operated in compliance with the requirements of section 521 and § 1.521–1, there shall be allowed as deductions from the gross income of such organization, in addition to the other deductions allowable under chapter 1 of the Code (including the deductions allowed by section 1382(b)) the special deductions provided in section 1382(c) and paragraphs (b), (c), and (d) of this section.

(2) For the definition of terms used in this section, see section 1388 and § 1.1388–1; to determine the payment period for a taxable year, see section 1382(d) and § 1.1382–4.

(b) *Deduction for dividends paid on capital stock.* In the case of a taxable year beginning after December 31, 1962, there is allowed as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and § 1.521–1, amounts paid as dividends during the taxable year on the capital stock of such cooperative association. For the purpose of the preceding sentence, the term *capital stock* includes common stock (whether voting or nonvoting), preferred stock, or any other form of capital represented by capital retain certificates, revolving fund certificates, letters of advice, or other evidence of a proprietary interest in a cooperative association. Such deduction is applicable only to the taxable year in which the dividends are actually or constructively paid to the holder of capital stock or other proprietary interest in the cooperative association. If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mail, in a cover properly stamped and addressed to the shareholder at his last known address, at such time that in the ordinary handling of the mails the check would be received by such holder within the taxable year, a presumption arises that the dividend was paid to such holder in such year. The determination of whether a dividend has been paid to such holder by the corporation during its taxable year is in no way dependent upon the method of accounting regularly employed by the corporation in keeping its books. For further rules as to the determination of the right to a deduction for dividends paid, under certain specific circumstances, see section 561 and the regulations thereunder.

(c) *Deduction for amounts allocated from income not derived from patronage*—(1) *In general.* In the case of a taxable year beginning after December 31, 1962, there is allowed as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and § 1.521–1, amounts paid to patrons, during the payment period for the taxable year, on a patronage basis with respect to its income derived during such taxable year either from business done with or for the United States or any of its agencies or from sources other than patronage, but only to the extent such amounts are paid in money, qualified written notices of allocation, or other property (other than nonqualified written notices of allocation). For purposes of this subparagraph a written notice of allocation is considered paid when it is issued to the patron. An amount shall be treated as paid in money during the payment period for the taxable year to the extent it is paid by a qualified check which is issued during the payment period for such taxable year and endorsed and cashed on or before the ninetieth day after the close of such payment period. In determining the amount paid which is allowable as a deduction under this paragraph, property (other than written notices of allocation) shall be taken into account at its fair market value when paid, and a qualified written notice of allocation shall be taken into account at its stated dollar amount.

(2) *Definition.* The term *income derived from sources other than patronage* used in this paragraph (c) means income from nonpatronage sources within the meaning of § 1.1388–1(f)(3).

(3) *Basis of distribution.* In order that the deduction for amounts paid with respect to income derived from business done with or for the United States or any of its agencies or from sources

other than patronage may be applicable, it is necessary that the amount sought to be deducted be paid on a patronage basis in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such income is attributable. For example, if capital gains are realized from the sale or exchange of capital assets acquired and disposed of during the taxable year, income realized from such gains must be paid to patrons of such year in proportion to the amount of business done by such patrons during the taxable year. Similarly, if capital gains are realized by the association from the sale or exchange of capital assets held for a period extending into more than one taxable year income realized from such gains must be paid, insofar as is practicable, to the persons who were patrons during the taxable years in which the asset was owned by the association in proportion to the amount of business done by such patrons during such taxable years.

(4) *Special rules for certain taxable years.* No deduction is allowable under this paragraph for amounts paid during taxable years beginning before January 1, 1963, or for amounts paid during taxable years beginning after December 31, 1962, with respect to income derived during taxable years beginning before January 1, 1963. With respect to such amounts, the Internal Revenue Code of 1954 (including section 522 and the regulations thereunder) shall be applicable without regard to subchapter T.

(d) *Deduction for amounts paid in redemption of certain nonqualified written notices of allocation.* In the case of a taxable year beginning after December 31, 1962, there is allowed as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and § 1.521–1, amounts paid by such association during the payment period for such taxable year in redemption of certain nonqualified written notices of allocation, but only to the extent such amounts (1) are paid in money or other property (other than written notices of allocation) and (2) do not exceed the stated dollar amount of such nonqualified written notices of allocation. The nonqualified written notices of allocation referred to in the preceding sentence are those which were previously paid to patrons on a patronage basis with respect to earnings derived either from business done with or for the United States or any of its agencies or from sources other than patronage, provided that such nonqualified written notices of allocation were paid during the payment period for the taxable year during which such earnings were derived. No deduction shall be allowed under this paragraph, however, for amounts paid in redemption of nonqualified written notices of allocation which were paid with respect to earnings derived during a taxable year beginning before January 1, 1963. For purposes of this paragraph, if an amount is paid within the payment period for two or more taxable years, it will be allowable as a deduction only for the earliest of such taxable years. In determining the amount paid which is allowable as a deduction under this paragraph, property (other than written notices of allocation) shall be taken into account at its fair market value when paid. Amounts paid in redemption of a nonqualified written notice of allocation in excess of its stated dollar amount shall be treated under the applicable provisions of the Code.

(e) *Applicability date.* Paragraph (c)(2) of this section applies to taxable years beginning after January 19, 2021. For taxable years beginning on or before January 19, 2021, taxpayers, however, may choose to apply the rules of paragraph (c)(2) of this section, provided the taxpayers apply the rules in their entirety and in a consistent manner.

[T.D. 6643, 28 FR 3155, Apr. 2, 1963, as amended by T.D. 9947, 86 FR 5593, Jan. 19, 2021]

§ 1.1382–4 Taxable income of cooperatives; payment period for each taxable year.

The payment period for a taxable year is the period beginning with the first day of such taxable year and ending with the fifteenth day of the ninth month following the close of such year.

[T.D. 6643, 28 FR 3156, Nov. 26, 1963]

§ 1.1382–5 Taxable income of cooperatives; products marketed under pooling arrangements.

For purposes of section 1382(b) and § 1.1382–2, in the case of a pooling arrangement for the marketing of products the patronage under such pool shall be treated as occurring during the taxable year in which the pool closes. The determination of when a pool is closed will be made on the basis of the facts and circumstances in each case, but generally the practices and operations of the cooperative organization shall control. This section may be illustrated by the following example:

Example: Farmer A delivers to the X Cooperative 100 bushels of wheat on August 15, 1963, at which time he receives a *per bushel* advance. (Both farmer A and the X Cooperative file returns on a calendar year basis.) On October 15, 1963 farmer A receives an additional *per bushel* payment. The pool sells some of its wheat in 1963 and the remainder in January of 1964. The pool is closed on February 15, 1964. For purposes of section 1382(b), A's patronage is considered as occurring in 1964.

[T.D. 6643, 28 FR 3156, Apr. 2, 1963]

§ 1.1382–6 Taxable income of cooperatives; treatment of earnings received after patronage occurred.

If earnings derived from business done with or for patrons are includible in the gross income of the cooperative organization for a taxable year after the taxable year during which the patronage occurred, then, for purposes of determining whether the cooperative is allowed a deduction under section 1382(b) and § 1.1382–2, the patronage to which these earnings relate shall be considered to have occurred during the taxable year for which such earnings are includible in the cooperative's gross income. Thus, if the cooperative organization pays these earnings out as patronage dividends during the payment period for the taxable year for which the earnings are includible in its gross income, it will be allowed a deduction for such payments under section 1382(b)(1) and paragraph (b) of § 1.1382–2, to the extent they are paid in money, qualified written notices of allocation, or other property (other than written notices of allocation).

[T.D. 6643, 28 FR 3156, Apr. 2, 1963]

§ 1.1382–7 Special rules applicable to cooperative associations exempt from tax before January 1, 1952.

(a) *Basis of property.* The adjustments to the cost or other basis provided in sections 1011 and 1016 and the regulations thereunder, are applicable for the entire period since the acquisition of the property. Thus, proper adjustment to basis must be made under section 1016 for depreciation, obsolescence, amortization, and depletion for all taxable years beginning prior to January 1, 1952, although the cooperative association was exempt from tax under section 521 or corresponding provisions of prior law for such years. However, no adjustment for percentage or discovery depletion is to be made for any year during which the association was exempt from tax. If a cooperative association has made a proper election in accordance with section 1020 and the regulations prescribed thereunder with respect to a taxable year beginning before 1952 in which the association was not exempt from tax, the adjustment to basis for depreciation for such years shall be limited in accordance with the provisions of section 1016(a)(2).

(b) *Amortization of bond premium.* In the case of tax exempt and partially taxable bonds purchased at a premium and subject to amortization under section 171, proper adjustment to basis must be made to reflect amortization with respect to such premium from the date of acquisition of the bond. (For principles governing the method of computation, see the example in paragraph (b) of § 1.1016–9, relating to mutual savings banks, building and loan associations, and cooperative banks.) The basis of a fully taxable bond purchased at a premium shall be adjusted from the date of the election to amortize such premium in accordance with the provisions of section 171 except that no adjustment shall be allowable for such portion of the premium attributable to the period prior to the election.

(c) *Amortization of mortgage premium.* In the case of a mortgage acquired at a premium where the principal of such mortgage is payable in installments, adjustments to the basis for the premium must be made for all taxable years (whether or not the association

was exempt from tax under section 521 during such years) in which installment payments are received. Such adjustments may be made on an individual mortgage basis or on a composite basis by reference to the average period of payments of the mortgage loans of such association. For the purpose of this adjustment, the term *premium* includes the excess of the acquisition value of the mortgage over its maturity value. The acquisition value of the mortgage is the cost including buying commissions, attorneys' fees, or brokerage fees, but such value does not include amounts paid for accrued interest.

[T.D. 6643, 28 FR 3156, Apr. 2, 1963]

§ 1.1383–1 Computation of tax where cooperative redeems nonqualified written notices of allocation.

(a) *General rule.* (1) If, during the taxable year, a cooperative organization is entitled to a deduction under section 1382 (b)(2) or (c)(2)(B) for amounts paid in redemption of nonqualified written notices of allocation, the tax imposed for the taxable year by chapter 1 of the Code shall be the lesser of:

(i) The tax for the taxable year computed under section 1383(a)(1), that is, with such deduction taken into account, or

(ii) The tax for the taxable year computed under section 1383(a)(2), that is, without taking such deduction into account, minus the decrease in tax (under chapter 1 of the Code) for any prior taxable year (or years) which would result solely from treating all such nonqualified written notices of allocation redeemed during the taxable year as qualified written notices of allocation when paid. For the purpose of this subdivision, the amount of the decrease in tax is not limited to the amount of the tax for the taxable year. See paragraph (c) of this section for rules relating to a refund of tax where the decrease in tax for the prior taxable year (or years) exceeds the tax for the taxable year.

(2) If the cooperative organization computes its tax for the taxable year under the provisions of section 1383(a)(2) and subparagraph (1)(ii) of this paragraph, then no deduction under section 1382 (b)(2) or (c)(2)(B) shall be taken into account in computing taxable income or loss for the taxable year, including the computation of any net operating loss carryback or carryover. However, the amount of the deduction shall be taken into account in adjusting earnings and profits for the taxable year.

(3) If the tax determined under subparagraph (1)(i) of this paragraph is the same as the tax determined under subparagraph (1)(ii) of this paragraph, the tax imposed for the taxable year under chapter 1 of the Code shall be the tax determined under subparagraph (1)(l) of this paragraph, and section 1383 and this section shall not otherwise apply. The tax imposed for the taxable year shall be the tax determined under subparagraph (1)(ii) of this paragraph in any case when a credit or refund would be allowable for the taxable year under section 1383(b)(1).

(b) *Determination of decrease in tax for prior taxable years*—(1) *Prior taxable years.* The prior taxable year (or years) referred to in paragraph (a) of this section is the year (or years) within the payment period for which the nonqualified written notices of allocation were paid and, in addition, any other prior taxable year (or years) which is affected by the adjustment to income by reason of treating such nonqualified written notices of allocation as qualified written notices of allocation when paid.

(2) *Adjustment to income in prior taxable years.* The deduction for the prior taxable year (or years) in determining the decrease in tax under section 1383(a)(2)(B) and paragraph (a)(1)(ii) of this section shall be the amount paid in redemption of the nonqualified written notices of allocation which, without regard to section 1383, is allowable as a deduction under section 1382 (b)(2) or (c)(2)(B) for the current taxable year.

(3) *Computation of decrease in tax for prior taxable years.* In computing the amount of decrease in tax for a prior taxable year (or years) resulting under this section, there must first be ascertained the amount of tax previously determined for the taxpayer for such prior taxable year (or years). The tax previously determined shall be the sum of the amounts shown as such tax

by the taxpayer on his return or returns, plus any amounts which have been previously assessed (or collected without assessment) as deficiencies, reduced by the amount of any rebates which have previously been made. The amount shown as the tax by the taxpayer on his return and the amount of any rebates or deficiencies shall be determined in accordance with the provisions of section 6211 and the regulations thereunder. After the tax previously determined has been ascertained, a recomputation must then be made to determine the decrease in tax, if any, resulting under this section. In determining the decrease in tax for the prior taxable year (or years), appropriate adjustment shall be made to any item which is dependent upon the amount of gross income or taxable income (such as charitable contributions, net operating losses, the foreign tax credit, and the dividends received credit).

(c) *Refunds*. If the decrease in tax for the prior taxable year (or years) determined under section 1383(a)(2)(B) and paragraph (a)(1)(ii) of this section exceeds the tax imposed by chapter 1 of the Code for the taxable year computed without the deduction under section 1382 (b) or (c)(2)(B), the excess shall be considered to be a payment of tax for the taxable year of the deduction. Such payment is deemed to have been made on the last day prescribed by law for the payment of tax for the taxable year and shall be refunded or credited in the same manner as if it were an overpayment of tax for such taxable year. See section 6151 and the regulations thereunder, for rules relating to time and place for paying tax shown on returns.

(d) *Example*. The application of section 1383 may be illustrated by the following example:

Example: The X Cooperative (which reports its income on a calendar year basis) pays patronage dividends of $100,000 in nonqualified written notices of allocation on February 1, 1964, with respect to patronage occurring in 1963. Since the patronage dividends of $100,000 were paid in nonqualified written notices of allocation the X Cooperative is not allowed a deduction for that amount for 1963. On December 1, 1966, the X Cooperative redeems these nonqualified written notices of allocation for $50,000. Under section 1382(b)(2), a deduction of $50,000 is allowable in computing its taxable income for 1966. However, the X Cooperative has a loss for 1966 determined without regard to this deduction. The X Cooperative, therefore, makes the computation under the alternative method provided in section 1383(a)(2). Under this alternative method, it will claim a credit or refund (as an overpayment of tax for 1966) of the decrease in tax for 1963 and for such other years prior to 1966 as are affected which results from recomputing its tax for 1963 and such other years affected) as if patronage dividends of $50,000 had been paid on February 1, 1964, in qualified written notices of allocation. In addition, under this alternative method the X Cooperative cannot use the $50,000 as a deduction for 1966 so as to increase its net operating loss for such year for purposes of computing a net operating loss carryback or carryover. If the X Cooperative also redeems on December 1, 1966, nonqualified written notices of allocation which were paid as patronage dividends on February 1, 1965, with respect to patronage occurring in 1964, it will claim a credit or refund (as an overpayment of tax for 1966) of the decrease in tax for 1964 and for such other years prior to 1966 as are affected. It shall not, however, apply one method for computing the tax with respect to the redemptions in 1966 of the nonqualified written notices of allocation paid in 1964 and the other method with respect to the redemption in 1966 of the nonqualified written notices of allocation paid in 1965.

[T.D. 6643, 28 FR 3156, Apr. 2, 1963]

TAX TREATMENT BY PATRONS OF PATRONAGE DIVIDENDS

§ 1.1385–1 Amounts includible in patron's gross income.

(a) *General rules*. Section 1385(a) requires every person to include in gross income the following amounts received by him during the taxable year, to the extent paid by the organization in money, a qualified written notice of allocation, or other property (other than a nonqualified written notice of allocation):

(1) The amount of any patronage dividend received from an organization subject to the provisions of part I, subchapter T, chapter 1 of the Code, unless such amount is excludable from gross income under the provisions of section 1385(b) and paragraph (c) of this section, and

(2) The amount of any distribution received from a farmers', fruit growers', or like association, organized and

operated in compliance with the requirements of section 521 and § 1.521–1, which is paid on a patronage basis with respect to earnings derived by such association either from business done with or for the United States or any of its agencies or from sources other than patronage.

The amounts described in subparagraphs (1) and (2) of this paragraph are includible in gross income for the taxable year in which they are received even though the cooperative organization was allowed a deduction for such amounts for its preceding taxable year because they were paid during the payment period for such preceding taxable year. Similarly, such amounts are includible in gross income even though the cooperative organization is not permitted any deduction for such amounts under the provisions of section 1382 because such amounts were not paid within the time prescribed by such section.

(b) *Treatment of certain nonqualified written notices of allocation.* (1) Except as provided in paragraph (c) of this section, any gain on the redemption, sale, or other disposition of a nonqualified written notice of allocation described in subparagraph (2) of this paragraph shall, to the extent that the stated dollar amount of such written notice of allocation exceeds its basis, be considered as gain from the sale or exchange of property which is not a capital asset, whether such gain is realized by the patron who received the nonqualified written notice of allocation initially or by any subsequent holder. Any amount realized on the redemption, sale, or other disposition of such a nonqualified written notice of allocation in excess of its stated dollar amount will be treated under the applicable provisions of the Code. For example, amounts received in redemption of a nonqualified written notice of allocation which are in excess of the stated dollar amount of such written notice of allocation and which, in effect, constitute interest shall be treated by the recipient as interest.

(2) The nonqualified written notices of allocation to which subparagraph (1) of this paragraph applies are the following:

(i) A nonqualified written notice of allocation which was paid as a patronage dividend (within the meaning of section 1388(a) and paragraph (a) of § 1.1388–1), by a cooperative organization subject to the provisions of part I of subchapter T, and

(ii) A nonqualified written notice of allocation which was paid by a farmers', fruit growers', or like association, organized and operated in compliance with the requirements of section 521 and § 1.521–1, to patrons on a patronage basis with respect to earnings derived either from business done with or for the United States or any of its agencies or from sources other than patronage.

(3) The basis of any nonqualified written notice of allocation described in subparagraph (2) of this paragraph, in the hands of the patron to whom such written notice of allocation was initially paid shall be zero, and the basis of such a written notice of allocation which was acquired from a decedent shall be its basis in the hands of the decedent.

(4) The application of this paragraph may be illustrated by the following example:

Example: A, a farmer, receives a patronage dividend from the X Cooperative, in the form of a nonqualified written notice of allocation, which is attributable to the sale of his crop to that cooperative organization. The stated dollar amount of the nonqualified written notice of allocation is $100. The basis of the written notice of allocation in the hands of A is zero and he must report any amount up to $100 received by him on its redemption, sale, or other disposition, as ordinary income. If A gives the written notice of allocation to his son B, B takes A's (the donor's) basis which is zero, and any gain up to $100 which B later realizes on its redemption, sale, or other disposition is ordinary income. Similarly, if A dies before realizing any gain on the nonqualified written notice of allocation, B, his legatee, has a zero basis for such written notice of allocation and any gain up to $100 which he then realizes on its redemption, sale, or other disposition is also ordinary income. Such gain is income in respect of a decedent within the meaning of section 691(a) and § 1.691(a)–1.

(c) *Treatment of patronage dividends received with respect to certain property*—(1) *Exclusions from gross income.* Except as provided in subparagraph (2) of this paragraph, gross income shall not include:

(i) Any amount of a patronage dividend described in paragraph (a)(1) of this section which is received with respect to the purchase of supplies, equipment, or services, which were not used in the trade or business and the cost of which was not deductible under section 212, or which is received with respect to the marketing or purchasing of a capital asset (as defined in section 1221) or property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167; and

(ii) Any amount (to the extent treated as ordinary income under paragraph (b) of this section) received on the redemption, sale, or other disposition of a nonqualified written notice of allocation which was received as a patronage dividend with respect to the purchase of supplies, equipment, or services, which were not used in the trade or business and the cost of which was not deductible under section 212, or which was received as a patronage dividend with respect to the marketing or purchasing of a capital asset (as defined in section 1221) or property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167.

(2) *Special rules.* (i) If an amount described in subparagraph (1) of this paragraph relates to the purchase of a capital asset (as defined in section 1221), or property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167, and the person receiving such amount owned such asset or property at any time during the taxable year in which such amount is received, then such amount shall be taken into account as an adjustment to the basis of such property or asset as of the first day of the taxable year in which such amount is received. To the extent that such amount exceeds the adjusted basis of such property it shall be taken into account as ordinary income.

(ii) If an amount described in subparagraph (1) of this paragraph relates to the marketing or purchasing of a capital asset (as defined in section 1221), or property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167, and the person receiving such amount did not own the asset or property at any time during the taxable year in which such amount is received, then such amount shall be included in gross income as ordinary income except that:

(*a*) If such amount relates to a capital asset (as defined in section 1221) which was held by the recipient for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and with respect to which a loss was or would have been deductible under section 165, such amount shall be taken into account as gain from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977);

(*b*) If such amount relates to a capital asset (as defined in section 1221) with respect to which a loss was not or would not have been deductible under section 165, such amount shall not be taken into account.

(iii) If an amount described in subparagraph (1) of this paragraph relates to the marketing of a capital asset (as defined in section 1221) or property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167, and such amount is received by the patron in the same taxable year during which he marketed the asset to which it relates, such amount shall be treated as an additional amount received on the sale or other disposition of such asset.

(iv) If a person receiving a patronage dividend or an amount on the redemption, sale, or other disposition of a nonqualified written notice of allocation which was received as a patronage dividend is unable to determine the item to which it relates, he shall include such patronage dividend or such amount in gross income as ordinary income in the manner and to the extent provided in paragraph (a) or (b) of this section, whichever is applicable.

(3) The application of this paragraph may be illustrated by the following examples:

Example 1. On July 1, 1964, P, a patron of a cooperative association, purchases an implement for use in his farming business from

such association for $2,900. The implement has an estimated useful life of three years and has an estimated salvage value of $200 which P chooses to take into account in the computation of depreciation. P files his income tax returns on a calendar year basis. For 1964 P claims depreciation of $450 with respect to the implement pursuant to his use of the straight-line method at the rate of $900 per year. On July 1, 1965, the cooperative association pays a patronage dividend to P of $300 in cash with respect to his purchase of the farm implement. P will adjust the basis of the implement and will compute his depreciation deduction for 1965 (and subsequent taxable years) as follows:

Cost of farm implement, July 1, 1964	$2,900
Less:	
Salvage value	200
Depreciation for 1964 (6 months)	450
Adjustment as of January 1, 1965 for cash patronage dividend	300
Total	950
Basis for depreciation for the remaining 2½ years of estimated life	1,950
Depreciation deduction for 1965 ($1,950 divided by the 2½ years of remaining life)	700

Example 2. Assume the same facts as in example (1), except that on July 1, 1965, the cooperative association paid a patronage dividend to P with respect to his purchase of the implement in the form of a nonqualified written notice of allocation having a stated dollar amount of $300. Since such written notice of allocation was not qualified, no amount of the patronage dividend was taken into account by P as an adjustment to the basis of the implement, or in computing his depreciation deduction, for the year 1965. In 1968, P receives $300 cash from the association in full redemption of the written notice of allocation. Prior to 1968, he had recovered through depreciation $2,700 of the cost of the implement, leaving an adjusted basis of $200 (the salvage value). For the year 1968, the redemption proceeds of $300 are applied against the adjusted basis of $200, reducing the basis of the implement to zero, and the balance of the redemption proceeds, $100, is includable as ordinary income in P's gross income for the calendar year 1968. If the patronage dividend paid to P on July 1, 1965, had been in the form of $60 cash (20 percent of $300) and a qualified written notice of allocation with a stated dollar amount of $240, then the tax treatment of such patronage dividend would be that illustrated in example (1).

Example 3. Assume the same facts as in example (2), except that the nonqualified written notice of allocation is redeemed in cash on July 1, 1966. The full $300 received on redemption will reduce the adjusted basis of the implement as of January 1, 1966, and the depreciation allowances for 1966 and 1967 are computed as follows:

Cost of farm implement, July 1, 1964	$2,900
Less:	
Salvage value	200
Depreciation for 1964 (6 months)	450
Depreciation for 1965	900
Adjustment as of January 1, 1966 for proceeds of the redemption	300
Total	1,850
Basis for depreciation on Jan. 1, 1966	1,050
If P uses the implement in his business until fully depreciated, he would be entitled to the following depreciation allowances with respect to such implement:	
For 1966	700
For 1967	350
Total	1,050
Balance to be depreciated	0

Example 4. Assume the same facts as in example (3), except that P sells the implement in 1965. The entire $300 received in 1966 in redemption of the nonqualified written notice of allocation is includible as ordinary income in P's gross income for the year 1966.

(d) *Determination of amount received.* In determining the amount received for purposes of this section:

(1) Property (other than written notices of allocation) shall be taken into account at its fair market value when received;

(2) A qualified written notice of allocation shall be taken into account at its stated dollar amount; and

(3) The amount of a qualified check shall be considered an amount received in money during the taxable year in which such check is received if the check is endorsed and cashed on or before the ninetieth day after the close of the payment period for the taxable year of the cooperative organization in which the patronage to which such amount relates occurred.

(e) *Effective date.* This section shall not apply to any distribution or allocation received from a cooperative organization, or to any gain or loss on the redemption, sale, or other disposition of any allocation received from such an organization, if such distribution or allocation was received with respect to patronage occurring in a taxable year of the organization beginning before January 1, 1963. See § 1.61–5 for the tax treatment by patrons of such distributions or allocations.

[T.D. 6643, 28 FR 3157, Apr. 2, 1963, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

DEFINITIONS; SPECIAL RULES

§ 1.1388–1 Definitions and special rules.

(a) *Patronage dividend*—(1) *In general.* The term *patronage dividend* means an amount paid to a patron by a cooperative organization subject to the provisions of part I, subchapter T, chapter 1 of the Code, which is paid:

(i) On the basis of quantity or value of business done with or for such patron,

(ii) Under a valid enforceable written obligation of such organization to the patron to pay such amount, which obligation existed before the cooperative organization received the amount so paid, and

(iii) Which is determined by reference to the net earnings of the cooperative organization from business done with or for its patrons.

For the purpose of subdivision (ii) of this subparagraph, amounts paid by a cooperative organization are paid under a valid enforceable written obligation if such payments are required by State law or are paid pursuant to provisions of the bylaws, articles of incorporation, or other written contract, whereby the organization is obligated to make such payment. The term *net earnings*, for purposes of subdivision (iii) of this subparagraph, includes the excess of amounts retained (or assessed) by the organization to cover expenses or other items over the amount of such expenses or other items. For purposes of such subdivision (iii), net earnings shall not be reduced by any taxes imposed by subtitle A of the Code, but shall be reduced by dividends paid on capital stock or other proprietary capital interests.

(2) *Exceptions.* The term *patronage dividend* does not include the following:

(i) An amount paid to a patron by a cooperative organization to the extent that such amount is paid out of earnings not derived from business done with or for patrons.

(ii) An amount paid to a patron by a cooperative organization to the extent that such amount is paid out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. Thus, if a cooperative organization does not pay any patronage dividends to nonmembers, any portion of the amounts paid to members which is out of net earnings from patronage with nonmembers, and which would have been paid to the nonmembers if all patrons were treated alike, is not a patronage dividend.

(iii) An amount paid to a patron by a cooperative organization to the extent that such amount is paid in redemption of capital stock, or in redemption or satisfaction of certificates of indebtedness, revolving fund certificates, retain certificates, letters of advice, or other similar documents, even if such documents were originally paid as patronage dividends.

(iv) An amount paid to a patron by a cooperative organization to the extent that such amount is fixed without reference to the net earnings of the cooperative organization from business done with or for its patrons.

(3) *Examples.* The application of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. (i) Cooperative A, a marketing association operating on a pooling basis, receives the products of patron W on January 5, 1964. On the same day cooperative A advances to W 45 cents per unit for the products so delivered and allocates to him a *retain certificate* having a face value calculated at the rate of 5 cents per unit. During the operation of the pool, and before substantially all the products in the pool are disposed of, cooperative A advances to W an additional 40 cents per unit, the amount being determined by reference to the market price of the products sold and the anticipated price of the unsold products. At the close of the pool on November 10, 1964, cooperative A determines the excess of its receipts over the sum of its expenses and its previous advances to patrons, and allocates to W an additional 3 cents per unit and shares of the capital stock of A having an aggregate stated dollar amount calculated at the rate of 2 cents per unit. Under the provisions of section 1382(e), W's patronage is deemed to occur in 1964, the year in which the pool is closed.

(ii) The patronage dividend paid to W during 1964 amounts to 5 cents per unit, consisting of the aggregate of the following per-unit allocations: The amount of the cash distribution (3 cents), and the stated dollar amount of the capital stock of A (2 cents), which are fixed with reference to the net

earnings of A. The amount of the two distributions in cash (85 cents) and the face amount of the *retain certificate* (5 cents), which are fixed without reference to the net earnings of A, do not constitute patronage dividends.

Example 2. Cooperative B, a marketing association operating on a pooling basis, receives the products of patron X on March 5, 1964. On the same day cooperative B pays to X $1.00 per unit for such products, this amount being determined by reference to the market price of the product when received, and issues to him a participation certificate having no face value but which entitles X on the close of the pool to the proceeds derived from the sale of his products less the previous payment of $1.00 and the expenses and other charges attributable to such products. On March 5, 1967, cooperative B, having sold the products in the pool, having deducted the previous payments for such products, and having determined the expenses and other charges of the pool pays to X, in cash, 10 cents per unit pursuant to the participation certificate. Under the provisions of section 1382(e), X's patronage is deemed to occur in 1967, the year in which the pool is closed. The payment made to X during 1967, amounting to 10 cents per unit, is a patronage dividend. Neither the payment to X in 1964 of $1.00 nor the issuance to him of the participation certificate in that year constitutes a patronage dividend.

Example 3. Cooperative C, a purchasing association, obtains supplies for patron Y on May 1, 1964, and receives in return therefor $100. On February 1, 1965, cooperative C, having determined the excess of its receipts over its costs and expenses, pays to Y a cash distribution of $1.00 and a revolving fund certificate with a stated dollar amount of $1.00. The amount of patronage dividend paid to Y in 1965 is $2.00, the aggregate of the cash distribution ($1.00) and the stated dollar amount of the revolving fund certificate ($1.00).

Example 4. Cooperative D, a service association, sells the products of members on a fee basis. It receives the products of patron Z under an agreement not to pool his products with those of other members, to sell his products, and to deliver to him the proceeds of the sale. Patron Z makes payments to cooperative D during 1964 aggregating $75 for service rendered him by cooperative D during that year. On May 15, 1965, cooperative D, having determined the excess of its receipts over its costs and expenses, pays to Z a cash distribution of $2.00. Such amount is a patronage dividend paid by cooperative D during 1965.

(b) *Written notice of allocation.* The term *written notice of allocation* means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses to the patron the stated dollar amount allocated to him on the books of the cooperative organization, and the portion thereof, if any, which constitutes a patronage dividend. Thus, a mere credit to the account of a patron on the books of the organization without disclosure to the patron, is not a written notice of allocation. A written notice of allocation may disclose to the patron the amount of the allocation which constitutes a patronage dividend either as a dollar amount or as a percentage of the stated dollar amount of the written notice of allocation.

(c) *Qualified written notice of allocation*—(1) *In general.* The term *qualified written notice of allocation* means a written notice of allocation:

(i) Which meets the requirements of subparagraphs (2) or (3) of this paragraph, and

(ii) Which is paid as part of a patronage dividend, or as part of a payment by a cooperative association organized and operated in compliance with the provisions of section 521 and § 1.521–1 to patrons on a patronage basis with respect to earnings derived from business done with or for the United States or any of its agencies or from sources other than patronage, that also includes a payment in money or by qualified check equal to at least 20 percent of such patronage dividend or such payment.

In determining, for purposes of subdivision (ii) of this subparagraph, whether 20 percent of a patronage dividend or a payment with respect to nonpatronage earnings is paid in money or by qualified check, any portion of such dividend or payment which is paid in nonqualified written notices of allocation may be disregarded. Thus, if a cooperative pays a patronage dividend of $100 in the form of a nonqualified written notice of allocation with a stated dollar amount of $50, a written notice of allocation with a stated dollar amount of $40, and money in the amount of $10, the written notice of allocation with a stated dollar amount of $40 will constitute a qualified written notice of allocation if it meets the requirements of subparagraph (2) or (3) of this paragraph. A *payment in money*, as that

term is used in subdivision (ii) of this subparagraph, includes a payment by a check drawn on a bank but does not include a credit against amounts owed by the patron to the cooperative organization, a credit against the purchase price of a share of stock or of a membership in such organization, nor does it include a payment by means of a document redeemable by such organization for money.

(2) *Written notice of allocation redeemable in cash.* The term *qualified written notice of allocation* includes a written notice of allocation which meets the requirement of subparagraph (1)(ii) of this paragraph and which may be redeemed in cash at its stated dollar amount at any time within a period beginning on the date such written notice of allocation is paid and ending not earlier than 90 days from such date, but only if the distributee receives written notice of the right of redemption at the time he receives such written notice of allocation. The written notice of the right of redemption referred to in the preceding sentence shall be given separately to each patron. Thus, a written notice of the right of redemption which is published in a newspaper or posted at the cooperative's place of business would not be sufficient to qualify a written notice of allocation which is otherwise described in this subparagraph.

(3) *Consent of patron.* The term *qualified written notice of allocation* also includes written notice of allocation which meets the requirement of subparagraph (1)(ii) of this paragraph and which the distributee has consented, in a manner provided in this subparagraph, to take into account at its stated dollar amount as provided in section 1385 and § 1.1385–1.

(i) *Consent in writing.* A distributee may consent to take the stated dollar amount of written notices of allocation into account under section 1385 by signing and furnishing a written consent to the cooperative organization. No special form is required for the written consent so long as the document on which it is made clearly discloses the terms of the consent. Thus, the written consent may be made on a signed invoice, sales slip, delivery ticket, marketing agreement, or other document, on which appears the appropriate consent. Unless the written consent specifically provides to the contrary, it shall be effective with respect to all patronage occurring during the taxable year of the cooperative organization in which such consent is received by such organization and, unless revoked under section 1388(c)(3)(B), for all subsequent taxable years. Section 1388(c)(3)(B)(i) provides that a written consent may be revoked by the patron at any time. Thus, any written consent which is, by its terms, irrevocable is not a consent that would qualify a written notice of allocation. A revocation, to be effective, must be in writing, signed by the patron, and furnished to the cooperative organization. Such a revocation shall be effective only with respect to patronage occurring after the close of the taxable year of the cooperative organization during which the revocation is filed with it. In the case of a pooling arrangement described in section 1382(e) and § 1.1382–5, a written consent which is made at any time before the close of the taxable year of the cooperative organization during which the pool closes shall be effective with respect to all patronage under that pool. In addition, any subsequent revocation of such consent by the patron will not be effective for that pool or any other pool with respect to which he has been a patron before such revocation.

(ii) *Consent by membership. (a)* A distributee may consent to take the stated dollar amount of written notices of allocation into account under section 1385 by obtaining or retaining membership in the cooperative organization after such organization has adopted a valid bylaw providing that membership in such cooperative organization constitutes such consent, but such consent shall take effect only after the distributee has received a written notification of the adoption of the bylaw provision and a copy of such bylaw. The bylaw must have been adopted by the cooperative organization after October 16, 1962, and must contain a clear statement that membership in the cooperative organization constitutes the prescribed consent. The written notification from the cooperative organization must inform the patron that this

bylaw has been adopted and of its significance. The notification and copy of the bylaw shall be given separately to each member (or prospective member); thus, a written notice and copy of the bylaw which are published in a newspaper or posted at the cooperative's place of business are not sufficient to qualify a written notice of allocation under this subdivision. A member (or prospective member) is presumed to have received the notification and copy of the bylaw if they were sent to his last known address by ordinary mail. A prospective member must receive the notification and copy of the bylaw before he becomes a member of the organization in order to have his membership in the organization constitute consent. A consent made in the manner described in this subdivision shall be effective only with respect to patronage occurring after the patron has received a copy of the bylaw and the prerequisite notice and while he is a member of the organization. Thus, any such consent shall not be effective with respect to any patronage occurring after the patron ceases to be a member of the cooperative organization or after the bylaw provision is repealed by such organization. In the case of a pooling arrangement described in section 1382(e) and §1.1382–5, a consent made under this subdivision will be effective only with respect to the patron's actual patronage occurring after he receives the notification and copy of the bylaw and while he is a member of the cooperative organization. Thus such a consent shall not be effective with respect to any patronage under a pool after the patron ceases to be a member of the cooperative organization or after the bylaw provisions is repealed by the organization.

(*b*) The following is an example of a bylaw provision which would meet the requirements prescribed in (*a*) of this subdivision.

Example: Each person who hereafter applies for and is accepted to membership in this cooperative and each member of this cooperative on the effective date of this bylaw who continues as a member after such date shall, by such act alone, consent that the amount of any distributions with respect to his patronage occurring after _____, which are made in written notices of allocation (as defined in 26 U.S.C. 1388) and which are received by him from the cooperative, will be taken into account by him at their stated dollar amounts in the manner provided in 26 U.S.C. 1385(a) in the taxable year in which such written notices of allocation are received by him.

(*c*) For purposes of this subdivision the term *member* means a person who is entitled to participate in the management of the cooperative organization.

(iii) *Consent by qualified check. (a)* A distributee may consent to take the stated dollar amount of a written notice of allocation into account under section 1385 by endorsing and cashing a qualified check which is paid as a part of the same patronage dividend or payment described in subparagraph (1)(ii) of this paragraph of which the written notice of allocation is also a part. In order to constitute an effective consent under this subdivision, however, the qualified check must be endorsed and cashed by the payee on or before the ninetieth day after the close of the payment period for the taxable year of the cooperative organization with respect to which the patronage dividend or payment is paid (or on or before such earlier day as may be prescribed by the cooperative organization). The endorsing and cashing of a qualified check shall be considered a consent only with respect to written notices of allocation which are part of the same patronage dividend or payment as the qualified check and for which a consent under subdivision (i) or (ii) of this subparagraph is not in effect. A qualified check is presumed to be endorsed and cashed within the 90-day period if the earliest bank endorsement which appears thereon bears a date no later than 3 days after the end of such 90-day period (excluding Saturdays, Sundays, and legal holidays).

(*b*) The term *qualified check* means a check, or other instrument redeemable in money, which is paid as a part of a patronage dividend or payment described in subparagraph (1)(ii) of this paragraph, on which there is clearly imprinted a statement that the endorsement and cashing of the check or other instrument constitutes the consent of the payee to take into account, as provided in the Federal income tax laws, the stated dollar amount of any written notices of allocation which are

paid as a part of the patronage dividend or payment of which such check or other instrument is also a part. A qualified check need not be in the form of an ordinary check which is payable through the banking system. It may, for example, be in the form of an instrument which is redeemable in money by the cooperative organization. The term *qualified check* does not include a check or other instrument paid as part of a patronage dividend or payment with respect to which a consent under subdivision (i) or (ii) of this subparagraph is in effect. In addition, the term *qualified check* does not include a check or other instrument which is paid as part of a patronage dividend or payment, if such patronage dividend or payment does not also include a written notice of allocation (other than a written notice of allocation that may be redeemed in cash at its stated dollar amount which meets the requirements of section 1388(c)(1)(A) and subparagraph (2) of this paragraph). Thus, a check which is paid as part of a patronage dividend is not a qualified check (even though it has the required statement imprinted on it) if the remaining portion of such patronage dividend is paid in cash or if the only written notices of allocation included in the payment are qualified under section 1388(c)(1)(A) and subparagraph (2) of this paragraph (relating to certain written notices of allocation which are redeemable by the patron within a period of at least 90 days).

(*c*) The provisions of this subdivision may be illustrated by the following example.

Example: (1) The A Cooperative is a cooperative organization filing its income tax returns on a calendar year basis. None of its patrons have consented in the manner prescribed in section 1388(c)(2) (A) or (B). On August 1, 1964, the A Cooperative pays patronage dividends to its patrons with respect to their 1963 patronage, and the payment to each such patron is partly by a qualified check and partly in the form of a written notice of allocation which is not redeemable for cash. Each patron who endorses and cashes his qualified check on or before December 14, 1964 (the ninetieth day following the close of the 1963 payment period) shall be considered to have consented with respect to the accompanying written notice of allocation and the amount of such check is treated as a patronage dividend paid in money on August 1, 1964.

(*2*) As to any patron who has not endorsed and cashed his qualified check by December 14, 1964, there is no consent and both the written notice of allocation and the qualified check constitute nonqualified written notices of allocation within the meaning of section 1388(d) and paragraph (d) of this section. If such a patron then cashes his check on January 2, 1965, he shall treat the amount received as an amount received on January 2, 1965, in redemption of a nonqualified written notice of allocation. Likewise, the cooperative shall treat the amount of the check as an amount paid on January 2, 1965, in redemption of a nonqualified written notice of allocation.

(*d*) *Nonqualified written notice of allocation*. The term *nonqualified written notice of allocation* means a written notice of allocation which is not a qualified written notice of allocation described in section 1388(c) and paragraph (c) of this section, or a qualified check which is not cashed on or before the ninetieth day after the close of the payment period for the taxable year of the cooperative organization for which the payment of which it is a part is paid.

(*e*) *Patron*. The term *patron* includes any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association.

(f) *Patronage and nonpatronage sourced items*—(1) *Directly related use test*. Whether an item of income or deduction is patronage or nonpatronage sourced is determined by applying the directly related use test.

(2) *Patronage sourced income or deductions*. If the income or deduction is produced by a transaction that actually facilitates the accomplishment of the cooperative's marketing, purchasing, or services activities, the income or deduction is from patronage sources.

(3) *Nonpatronage sourced income or deductions*. If the transaction producing the income or deduction does not actually facilitate the accomplishment of the cooperative's marketing, purchasing, or services activities but

merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income or deduction is from nonpatronage sources.

(g) *Applicability date.* Paragraph (f) of this section applies to taxable years beginning after January 19, 2021. Taxpayers, however, may choose to apply the rules of paragraph (f) of this section for taxable years beginning on or before that date, provided the taxpayers apply the rules in their entirety and in a consistent manner.

[T.D. 6643, 28 FR 3160, Apr. 2, 1963, as amended by T.D. 9947, 86 FR 5593, Jan. 19, 2021]

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[T.D. 8673, 61 FR 27259, May 31, 1996]

§ 1.1394–1 Enterprise zone facility bonds.

(a) *Scope.* This section contains rules relating to tax-exempt bonds under section 1394 (enterprise zone facility bonds) to provide enterprise zone facilities in both empowerment zones and enterprise communities (zones). See sections 1394, 1397B, and 1397C for other rules and definitions.

(b) *Period of compliance*—(1) *In general.* Except as provided in paragraphs (b)(2) and (c) of this section, the requirements under sections 1394 (a) and (b) applicable to enterprise zone facility bonds must be complied with throughout the greater of the following—

(i) The remainder of the period during which the zone designation is in effect under section 1391 (zone designation period); and

(ii) The period that ends on the weighted average maturity date of the enterprise zone facility bonds.

(2) *Compliance after an issue is retired.* Except as provided in paragraph (c)(3) of this section, the requirements applicable to enterprise zone facility bonds do not apply to an issue after the date on which no enterprise zone facility bonds of the issue are outstanding.

(3) *Deemed compliance*—(i) *General rule.* An issue is deemed to comply with the requirements of sections 1394 (a) and (b) if—

(A) The issuer and the principal user in good faith attempt to meet the requirements of sections 1394 (a) and (b) throughout the period of compliance required under this section; and

(B) Any failure to meet these requirements is corrected within a one-year period after the failure is first discovered.

(ii) *Exception*. The provisions of paragraph (b)(3)(i) of this section do not apply to the requirements of section 1397B(d)(5)(A) (relating to certain prohibited business activities).

(iii) *Good faith*. In order to satisfy the good faith requirement of paragraph (b)(3)(i)(A) of this section, the principal user must at least annually demonstrate to the issuer the principal user's monitoring of compliance with the requirements of sections 1394 (a) and (b).

(c) *Special rules for requirements of sections 1397B and 1397C*—(1) *Start of compliance period*. Except as provided in paragraph (c)(2) of this section, the requirements of sections 1397B (relating to qualification as an enterprise zone business) and 1397C (relating to satisfaction of the rules for qualified zone property) do not apply prior to the *initial testing date* (as defined in paragraph (c)(4) of this section) if—

(i) The issuer and the principal user reasonably expect on the issue date of the enterprise zone facility bonds that those requirements will be met by the principal user on or before the initial testing date; and

(ii) The issuer and the principal user exercise due diligence to meet those requirements prior to the initial testing date.

(2) *Compliance period for certain prohibited activities*. The requirements of section 1397B(d)(5)(A) (relating to certain prohibited business activities) must be complied with throughout the term of the enterprise zone facility bonds.

(3) *Minimum compliance period*. The requirements of sections 1397B (b) or (c) and 1397C must be satisfied for a continuous period of at least three years after the initial testing date, notwithstanding that—

(i) The period of compliance required under paragraph (b)(1) of this section expires before the end of the three-year period; or

(ii) The enterprise zone facility bonds are retired before the end of the three-year period.

(4) *Initial testing date*—(i) *In general*. Except as otherwise provided in paragraph (c)(4)(ii) of this section, the initial testing date is the date that is 18 months after the later of the issue date of the enterprise zone facility bonds or the date on which the financed property is placed in service; provided, however, it is not later than—

(A) Three years after the issue date; or

(B) Five years after the issue date, if the issue finances a construction project for which both the issuer and a licensed architect or engineer certify on or before the issue date of the enterprise zone facility bonds that more than three years after the issue date is necessary to complete construction of the project.

(ii) *Alternative initial testing date*. If the issuer identifies as the initial testing date a date after the issue date of the enterprise zone facility bonds and prior to the initial testing date that would have been determined under paragraph (c)(4)(i) of this section, that earlier date is treated as the initial testing date.

(d) *Testing on an average basis*. Compliance with each of the requirements of section 1397B (b) or (c) is tested each taxable year. Compliance with any of the requirements may be tested on an average basis, taking into account up to four immediately preceding taxable years plus the current taxable year. The earliest taxable year that may be taken into account for purposes of the preceding sentence is the taxable year that includes the initial testing date. A taxable year is disregarded if the part of the taxable year that falls in a required compliance period does not exceed 90 days.

(e) *Resident employee requirements*—(1) *Determination of employee status*. For purposes of the requirement of section 1397B (b)(6) or (c)(5) that at least 35 percent of the employees are residents of the zone, the issuer and the principal user may rely on a certification, signed under penalties of perjury by the employee, provided—

(i) The certification provides to the principal user the address of the employee's principal residence;

(ii) The employee is required by the certification to notify the principal user of a change of the employee's principal residence; and

(iii) Neither the issuer nor the principal user has actual knowledge that the principal residence set forth in the

certification is not the employee's principal residence.

(2) *Employee treated as zone resident.* If an issue fails to comply with the requirement of section 1397B (b)(6) or (c)(5) because an employee who initially resided in the zone moves out of the zone, that employee is treated as still residing in the zone if—

(i) That employee was a bona fide resident of the zone at the time of the certification described in paragraph (e)(1) of this section;

(ii) That employee continues to perform services for the principal user in an enterprise zone business and substantially all of those services are performed in the zone; and

(iii) A resident of the zone meeting the requirements of section 1397B (b)(5) or (c)(4) is hired by the principal user for the next available comparable (or lesser) position.

(3) *Resident employee percentage.* For purposes of meeting the requirement of section 1397B (b)(6) or (c)(5) that at least 35 percent of the employees of an enterprise zone business are residents of a zone, paragraphs (e)(3) (i) and (ii) of this section apply.

(i) The term *employee* includes a self-employed individual within the meaning of section 401(c)(1).

(ii) The resident employee percentage is determined on any reasonable basis consistently applied throughout the period of compliance required under this section. The per-employee fraction (as defined in paragraph (e)(3)(ii)(A) of this section) or the employee actual work hour fraction (as defined in paragraph (e)(3)(ii)(B) of this section) are both reasonable methods.

(A) The term *per-employee fraction* means the fraction, the numerator of which is, during the taxable year, the number of employees who work at least 15 hours a week for the principal user, who reside in the zone, and who are employed for at least 90 days, and the denominator of which is, during the same taxable year, the aggregate number of all employees who work at least 15 hours a week for the principal user and who are employed for at least 90 days.

(B) The term *employee actual work hour fraction* means the fraction, the numerator of which is the aggregate total actual hours of work for the principal user of employees who reside in the zone during a taxable year, and the denominator of which is the aggregate total actual hours of work for the principal user of all employees during the same taxable year.

(f) *Application to pooled financing bond and loan recycling programs.* In the case of a pooled financing bond program described in paragraph (g)(2) of this section or a loan recycling program described in paragraph (m)(2)(ii) of this section, the requirements of paragraphs (b) through (e) of this section apply on a loan-by-loan basis. See also paragraphs (g)(2) (relating to limitation on amount of bonds), (m)(2) (relating to maturity limitations), (m)(3) (relating to volume cap), and (m)(4) (relating to remedial actions) of this section.

(g) *Limitation on amount of bonds*—(1) *Determination of outstanding amount.* Whether an issue satisfies the requirements of section 1394(c) (relating to the $3 million and $20 million aggregate limitations on the amount of outstanding enterprise zone facility bonds) is determined as of the issue date of that issue, based on the issue price of that issue and the adjusted issue price of outstanding enterprise zone facility bonds. Amounts of outstanding enterprise zone facility bonds allocable to any entity are determined under rules contained in section 144(a)(10)(C) and the underlying regulations. Thus, the definition of *principal user* for purposes of section 1394(c) is different from the definition of principal user for purposes of paragraph (j) of this section.

(2) *Pooled financing bond programs*—(i) *In general.* The limitations of section 1394(c) for an issue for a pooled financing bond program are determined with regard to the amount of the actual loans to enterprise zone businesses rather than the amount lent to *intermediary lenders* as defined in paragraph (g)(2)(ii) of this section. This paragraph (g)(2) applies only to the extent the proceeds of those enterprise zone facility bonds are loaned to one or more enterprise zone businesses within 42 months of the issue date of the enterprise zone facility bonds or are used to redeem enterprise zone facility bonds

of the issue within that 42-month period.

(ii) *Pooled financing bond program defined.* For purposes of this section, *a pooled financing bond program* is a program in which the issuer of enterprise zone facility bonds, in order to provide loans to enterprise zone businesses, lends the proceeds of the enterprise zone facility bonds to a bank or similar intermediary (intermediary lender) which must then relend the proceeds to two or more enterprise zone businesses.

(h) *Original use requirement for purposes of qualified zone property.* In general, for purposes of section 1397C(a)(1)(B), the term *original use* means the first use to which the property is put within the zone. For purposes of section 1394, if property is vacant for at least a one-year period including the date of zone designation, use prior to that period is disregarded for purposes of determining original use. For this purpose, de minimis incidental uses of property, such as renting the side of a building for a billboard, are disregarded.

(i) *Land.* The determination of whether land is functionally related and subordinate to qualified zone property is made in a manner consistent with the rules for exempt facilities under section 142.

(j) *Principal user*—(1) *In general.* Except as provided in paragraph (j)(2) of this section, the term *principal user* means the owner of financed property.

(2) *Rental of real property*—(i) *A lessee as the principal user.* If an owner of real property financed with enterprise zone facility bonds is not an enterprise zone business within the meaning of section 1397B, but the rental of the property is a qualified business within the meaning of section 1397B(d)(2), the term *principal user* for purposes of sections 1394 (b) and (e) means the lessee or lessees.

(ii) *Allocation of enterprise zone facility bonds.* If a lessee is the principal user of real property under paragraph (j)(2)(i) of this section, then proceeds of enterprise zone facility bonds may be allocated to expenditures for real property only to the extent of the property allocable to the lessee's leased space, including expenditures for common areas.

(3) *Pooled financing bond program.* An intermediary lender in a pooled financing bond program described in paragraph (g)(2) of this section is not treated as the principal user.

(k) *Treatment as separately incorporated business.* For purposes of section 1394(b)(3)(B), a trade or business may be treated as separately incorporated if allocations of income and activities attributable to the business conducted within the zone are made using a reasonable allocation method and if that trade or business has evidence of those allocations sufficient to establish compliance with the requirements of paragraphs (b) through (f) of this section. Whether an allocation method is reasonable will depend upon the facts and circumstances. An allocation method will not be considered to be reasonable unless the allocation method is applied consistently by the trade or business and is consistent with the purposes of section 1394.

(l) *Substantially all.* For purposes of sections 1397B and 1397C(a), the term *substantially all* means 85 percent.

(m) *Application of sections 142 and 146 through 150*—(1) *In general.* Except as provided in this paragraph (m), enterprise zone facility bonds are treated as exempt facility bonds that are described in section 142(a), and all regulations generally applicable to exempt facility bonds apply to enterprise zone facility bonds. For this purpose, enterprise zone businesses are treated as meeting the public use requirement. Sections 147(c)(1)(A) (relating to limitations on financing the acquisition of land), 147(d) (relating to financing the acquisition of existing property), and 142(b)(2) (relating to limitations on financing office space) do not apply to enterprise zone facility bonds. See also paragraph (n)(4) of this section.

(2) *Maturity limitation*—(i) *Requirements.* An issue of enterprise zone facility bonds, the proceeds of which are to be used as part of a loan recycling program, satisfies the requirements of section 147(b) if—

(A) Each loan satisfies the requirements of section 147(b) (determined by treating each separate loan as a separate issue); and

(B) The term of the issue does not exceed 30 years.

(ii) *Loan recycling program defined.* A *loan recycling program* is a program in which—

(A) The issuer reasonably expects as of the issue date of the enterprise zone facility bonds that loan repayments from principal users will be used to make additional loans during the zone designation period;

(B) Repayments of principal on loans (including prepayments) received during the zone designation period are used within six months of the date of receipt either to make new loans to enterprise zone businesses or to redeem enterprise zone facility bonds that are part of the issue; and

(C) Repayments of principal on loans (including prepayments) received after the zone designation period are used to redeem enterprise zone facility bonds that are part of the issue within six months of the date of receipt.

(3) *Volume cap.* For purposes of applying section 146(f)(5)(A) (relating to elective carryforward of unused volume limitation), issuing enterprise zone facility bonds is a carryforward purpose.

(4) *Remedial actions.* In the case of a pooled financing bond program described in paragraph (g)(2) of this section or a loan recycling program described in paragraph (m)(2)(ii) of this section, if a loan fails to meet the requirements of paragraphs (b) through (f) of this section, within six months of noncompliance (after taking into account the deemed compliance provisions of paragraph (b)(3) of this section, if applicable), an amount equal to the outstanding loan principal must be prepaid and the issuer must—

(i) Reloan the amount of the prepayment; or

(ii) Use the prepayment to redeem an amount of outstanding enterprise zone facility bonds equal to the outstanding principal amount of the loan that no longer meets those requirements.

(n) *Continuing compliance and change of use penalties*—(1) *In general.* The penalty provisions of section 1394(e) apply throughout the period of compliance required under paragraph (b)(1) of this section.

(2) *Coordination with deemed compliance provisions.* Section 1394(e)(2) does not apply during any period during which the issue is deemed to comply with the requirements of section 1394 under the deemed compliance provisions of paragraph (b)(3) of this section.

(3) *Application to pooled financing bond and loan recycling programs.* In the case of a pooled financing bond program described in paragraph (g)(2) of this section or a loan recycling program described in paragraph (m)(2)(ii) of this section, section 1394(e) applies on a loan-by-loan basis.

(4) *Section 150(b)(4) inapplicable.* Section 150(b)(4) does not apply to enterprise zone facility bonds.

(o) *Refunding bonds*—(1) *In general.* An issue of bonds issued after the zone designation period to refund enterprise zone facility bonds (other than in an advance refunding) are treated as enterprise zone facility bonds if the refunding issue and the prior issue, if treated as a single combined issue, would meet all of the requirements for enterprise zone facility bonds, except the requirements in section 1394(c). For example, the compliance period described in paragraph (b)(1) of this section is calculated taking into account any extension of the weighted average maturity of the refunding issue compared to the remaining weighted average maturity of the prior issue. The proceeds of the refunding issue are allocated to the same expenditures and purpose investments as the prior issue.

(2) *Maturity limitation.* The maturity limitation of section 147(b) is applied to a refunding issue by taking into account the issuer's reasonable expectations about the economic life of the financed property as of the issue date of the prior issue and the actual weighted average maturity of the combined refunding issue and prior issue.

(p) *Examples.* The following examples illustrate paragraphs (a) through (o) of this section:

Example 1. Averaging of enterprise zone business requirements. City C issues enterprise zone facility bonds, the proceeds of which are loaned by C to Corporation B to finance the acquisition of equipment for its existing business located in a zone. On the issue date of the enterprise zone facility bonds, B meets all of the requirements of section 1397B(b), except that only 25% of B's employees reside in the zone. C and B reasonably expect on the issue date to meet all requirements of section 1397B(b) by the date that is 18 months after the equipment is placed in

service (the initial testing date). In each of the first, second, and third taxable years after the initial testing date, 35%, 40% and 45%, respectively, of B's employees are zone residents. In the fourth year after the testing date, only 25% of B's employees are zone residents. B continues to meet the 35% resident employee requirement, because the average of zone resident employees for those four taxable years is approximately 36%. The percentage of zone residents employed by B before the initial testing date is not included in determining whether B continues to comply with the 35% resident employee requirement.

Example 2. Measurement of resident employee percentage. Authority D issues enterprise zone facility bonds, the proceeds of which are loaned to Sole Proprietor F to establish an accounting business in a zone. In the first year after the initial testing date, the staff working for F includes F, who works 40 hours per week and does not live in the zone, one employee who resides in the zone and works 40 hours per week, one employee who does not reside in the zone and works 20 hours per week, and one employee who does not reside in the zone and works 10 hours per week. F meets the 35% resident employee test by calculating the percentage on the basis of employee actual work hours as described in paragraph (e)(3)(ii)(B) of this section. If F uses the per-employee basis as described in paragraph (e)(3)(ii)(A) of this section to determine if the resident employee test is met, the percentage of employees who are zone residents on a per-employee basis is only 33% because F must exclude from the numerator and the denominator the employee who works only 10 hours per week. If F calculates the resident employee test as a percentage of employee actual work hours as described in paragraph (e)(3)(ii)(B) of this section in the first year, F must calculate the resident employee test as a percentage of employee actual work hours each year.

Example 3. Active conduct of business within the zone. State G issues enterprise zone facility bonds and loans the proceeds to Corporation H to finance the acquisition of equipment for H's mail order clothing business, which is located in a zone. H purchases the supplies for its clothing business from suppliers located both within and outside of the zone and expects that orders will be received both from customers who will reside or work within the zone and from others outside the zone. All orders are received and filled at, and are shipped from, H's clothing business located in the zone. H meets the requirement that at least 80% of its gross income is derived from the active conduct of business within the zone.

Example 4. Enterprise zone business definition. City J issues enterprise zone facility bonds, the proceeds of which are loaned to Partnership K to finance the acquisition of equipment for its printing operation located in the zone. All orders are taken and completed, and all billing and accounting activities are performed, at the print shop located in the zone. K, on occasion, uses its equipment (including its trucks) and employees to deliver large print jobs to customers who reside outside of the zone. So long as K is able to establish that its trucks are used in the zone at least 85% of the time and its employees perform at least 85% of services for K in the zone, K meets the requirements of sections 1397B(b) (3) and (5).

Example 5. Treatment as a separately incorporated business. The facts are the same as in *Example 4* except that six years after the issue date of the enterprise zone facility bonds, K determines to expand its operations to a second location outside of the boundaries of the zone. Although the expansion would result in the failure of K to meet the tests of 1397B(b), K, using a reasonable allocation method, allocates income and activities to its operations within the zone and has evidence of these allocations sufficient to establish compliance with the requirements of paragraphs (b) through (f) of this section. The bonds will not fail to be enterprise zone facility bonds merely because of the expansion.

Example 6. Treatment of pooled financing bond programs. Authority L issues bonds in the aggregate principal amount of $5,000,000 and loans the proceeds to Bank M pursuant to a loans-to-lenders program. M does not meet the definition of enterprise zone business contained in section 1397B. Prior to the issue date of the bonds, L held a public hearing regarding issuance of the bonds for the loans-to-lenders program, describing the projects of identified borrowers to be financed initially with $4,000,000 of the proceeds of the bonds. The applicable elected representative of L approved issuance of the bonds subsequent to the public hearing. The loan agreement between L and M provides that the other proceeds of the bonds will be held by M and loaned to borrowers that qualify as enterprise zone businesses, following a public hearing and approval by the applicable elected representative of L of each loan by M to an enterprise zone business. None of the loans will be in principal amounts in excess of $3,000,000. The loans by M will otherwise meet the requirements of section 1394. The bonds will be enterprise zone facility bonds.

Example 7. Original use requirement for purposes of qualified zone property. City N issues enterprise zone facility bonds, the proceeds of which are loaned to Corporation P to finance the acquisition of equipment. P uses the proceeds after the zone designation date to purchase used equipment located outside of the zone and places the equipment in service at its location in the zone. Substantially all of the use of the equipment is in the zone

and is in the active conduct of a qualified business by P. The equipment is treated as qualified enterprise zone property under section 1397C because P makes the first use of the property within the zone after the zone designation date.

Example 8. Principal user. State R issues enterprise zone facility bonds and loans the proceeds to Partnership S to finance the construction of a small shopping center to be located in a zone. S is in the business of commercial real estate. S is not an enterprise zone business, but has secured one anchor lessee, Corporation T, for the shopping center. T would qualify as an enterprise zone business. S will derive 60% of its gross rental income of the shopping center from T. S does not anticipate that the remaining rental income will come from enterprise zone businesses. T will occupy 60% of the total rentable space in the shopping center. S can use enterprise zone facility bond proceeds to finance the portion of the costs of the shopping center allocable to T (60%) because T is treated as the principal user of the enterprise zone facility bond proceeds.

Example 9. Remedial actions. State W issues pooled financing enterprise zone facility bonds, the proceeds of which will be loaned to several enterprise zone businesses in the two enterprise communities and one empowerment zone in W. Proceeds of the pooled financing bonds are loaned to Corporation X, an enterprise zone business, for a term of 10 years. Six years after the date of the loan, X expands its operations beyond the empowerment zone and is no longer able to meet the requirements of section 1394. X does not reasonably expect to be able to cure the noncompliance. The loan documents provide that X must prepay its loan in the event of noncompliance. W does not expect to be able to reloan the prepayment by X within six months of noncompliance. X's noncompliance will not affect the qualification of the pooled financing bonds as enterprise zone facility bonds if W uses the proceeds from the loan prepayment to redeem outstanding enterprise zone facility bonds within six months of noncompliance in an amount comparable to the outstanding amount of the loan immediately prior to prepayment. X will be denied an interest expense deduction for the interest accruing from the first day of the taxable year in which the noncompliance began.

(q) *Effective dates*—(1) *In general.* Except as otherwise provided in this section, the provisions of this section apply to all issues issued after July 30, 1996, and subject to section 1394.

(2) *Elective retroactive application in whole.* An issuer may apply the provisions of this section in whole, but not in part, to any issue that is outstanding on July 30, 1996, and is subject to section 1394.

[T.D. 8673, 61 FR 27259, May 31, 1996]

EMPOWERMENT ZONE EMPLOYMENT CREDIT

§ 1.1396–1 Qualified zone employees.

(a) *In general.* A qualified zone employee of an employer is an employee who satisfies the location-of-services requirement and the abode requirement with respect to the same empowerment zone and is not otherwise excluded by section 1396(d).

(1) *Location-of-services requirement.* The location-of-services requirement is satisfied if substantially all of the services performed by the employee for the employer are performed in the empowerment zone in a trade or business of the employer.

(2) *Abode requirement.* The abode requirement is satisfied if the employee's principal place of abode while performing those services is in the empowerment zone.

(b) *Period for applying location-of-services requirement.* In applying the location-of-services requirement, an employer may use either the pay period method described in paragraph (b)(1) of this section or the calendar year method described in paragraph (b)(2) of this section. For each taxable year of an employer, the employer must either use the pay period method with respect to all of its employees or use the calendar year method with respect to all of its employees. The employer may change the method applied to all of its employees from one taxable year to the next.

(1) *Pay period method*—(i) *Relevant period.* Under the pay period method, the relevant period for applying the location-of-services requirement is each pay period in which an employee provides services to the employer during the calendar year with respect to which the credit is being claimed (*i.e.*, the calendar year that ends with or within the relevant taxable year). If an employer has one pay period for certain employees and a different pay period for other employees (e.g., a weekly pay period for hourly wage employees and a bi-weekly pay period for salaried

employees), the pay period actually applicable to a particular employee is the relevant pay period for that employee under this method.

(ii) *Application of method*. Under this method, an employee does not satisfy the location-of-services requirement during a pay period unless substantially all of the services performed by the employee for the employer during that pay period are performed within the empowerment zone in a trade or business of the employer.

(2) *Calendar year method*—(i) *Relevant period*. Under the calendar year method, the relevant period for an employee is the entire calendar year with respect to which the credit is being claimed. However, for any employee who is employed by the employer for less than the entire calendar year, the relevant period is the portion of that calendar year during which the employee is employed by the employer.

(ii) *Application of method*. Under this method, an employee does not satisfy the location-of-services requirement during any part of a calendar year unless substantially all of the services performed by the employee for the employer during that calendar year (or, if the employee is employed by the employer for less than the entire calendar year, the portion of that calendar year during which the employee is employed by the employer) are performed within the empowerment zone in a trade or business of the employer.

(3) *Examples*. This paragraph (b) may be illustrated by the following examples. In each example, the following assumptions apply. The employees satisfy the abode requirement at all relevant times and all services performed by the employees for their employer are performed in a trade or business of the employer. The employees are not precluded from being qualified zone employees by section 1396(d)(2) (certain employees ineligible). No portion of the employees' wages is precluded from being qualified zone wages by section 1396(c)(2) (only first $15,000 of wages taken into account) or section 1396(c)(3) (coordination with targeted jobs credit and work opportunity credit). The examples are as follows:

Example 1. (i) Employer X has a weekly pay period for all its employees. Employee A works for X throughout 1997. During each of the first 20 weekly pay periods in 1997, substantially all of A's work for X is performed within the empowerment zone in which A resides. A also works in the zone at various times during the rest of the year, but there is no other pay period in which substantially all of A's work for X is performed within the empowerment zone. Employer X uses the pay period method.

(ii) For each of the first 20 pay periods of 1997, A is a qualified zone employee, all of A's wages from X are qualified zone wages, and X may claim the empowerment zone employment credit with respect to those wages. X cannot claim the credit with respect to any of A's wages for the rest of 1997.

Example 2. (i) Employer Y has a weekly pay period for its factory workers and a bi-weekly pay period for its office workers. Employee B works for Y in various factories and Employee C works for Y in various offices. Employer Y uses the pay period method.

(ii) Y must use B's weekly pay periods to determine the periods (if any) in which B is a qualified zone employee. Y may claim the empowerment zone employment credit with respect to B's wages only for the weekly pay periods for which B is a qualified zone employee, because those are B's only wages that are qualified zone wages. Y must use C's bi-weekly pay periods to determine the periods (if any) in which C is a qualified zone employee. Y may claim the credit with respect to C's wages only for the bi-weekly pay periods for which C is a qualified zone employee, because those are C's only wages that are qualified zone wages.

Example 3. (i) Employees D and E work for Employer Z throughout 1997. Although some of D's work for Z in 1997 is performed outside the empowerment zone in which D resides, substantially all of it is performed within that empowerment zone. E's work for Z is performed within the empowerment zone in which E resides for several weeks of 1997 but outside the zone for the rest of the year so that, viewed on an annual basis, E's work is not substantially all performed within the empowerment zone. Employer Z uses the calendar year method.

(ii) D is a qualified zone employee for the entire year, all of D's 1997 wages from Z are qualified zone wages, and Z may claim the empowerment zone employment credit with respect to all of those wages, including the portion attributable to work outside the zone. Under the calendar year method, E is not a qualified zone employee for any part of 1997, none of E's 1997 wages are qualified zone wages, and Z cannot claim any empowerment zone employment credit with respect to E's wages for 1997. Z cannot use the calendar year method for D and the pay period method for E because Z must use the same method for all employees. For 1998, however, Z can switch to the pay period method for E

if Z also switches to the pay period method for D and all of Z's other employees.

(c) *Effective date*. This section applies with respect to wages paid or incurred on or after December 21, 1994.

[T.D. 8747, 62 FR 67727, Dec. 30, 1997]

§ 1.1397E–1 Qualified zone academy bonds.

(a) *In general*—(1) *Overview*. In general, a qualified zone academy bond (QZAB or QZABs) is a taxable bond issued by a state or local government the proceeds of which are used to improve certain eligible public schools. An eligible taxpayer that holds a QZAB generally is allowed annual Federal income tax credits in lieu of periodic interest payments. These credits compensate the eligible taxpayer for lending money to the issuer and function as payments of interest on the bond. Accordingly, this section generally treats the allowance of a credit as if it were a payment of interest on the bond. This section also provides other rules for QZABs, including rules governing the credit rate, the private business contribution requirement, the maximum term, use and expenditure of proceeds, remedial actions, eligible issuers, arbitrage investment restrictions, and information reporting.

(2) *Certain definitions*—(i) *In general*. For purposes of this section, except as otherwise provided in this section, the following definitions apply: the definitions set forth in this section; the definitions used for general tax-exempt bond purposes in § 1.150–1; and the definitions used for purposes of the arbitrage investment restrictions on tax-exempt bonds in § 1.148–1(b).

(ii) *Applicable definition of proceeds*—(A) *Use and expenditure provisions*. Except as provided in paragraphs (a)(2)(ii)(B) and (a)(2)(ii)(C) of this section, for purposes of all applicable requirements regarding use and expenditure of proceeds of QZABs under section 1397E and this section, ''proceeds'' means ''sale proceeds,'' as defined in § 1.148–1(b), plus ''investment proceeds,'' as defined in § 1.148–1(b).

(B) *Private business contribution requirement*. For purposes of the private business contribution requirement of section 1397E(d)(2), ''proceeds'' means ''sale proceeds,'' as defined in § 1.148–1(b).

(C) *Arbitrage investment restrictions*. For purposes of the scope of application of the arbitrage investment restrictions under section 1397E(g) and paragraph (i) of this section, ''proceeds'' generally means gross proceeds, as defined in § 1.148–1(b). In addition, in applying the arbitrage investment restrictions under paragraph (i) of this section and under section 148, the various applicable definitions of the various types of proceeds of tax-exempt bonds under § 1.148–1(b) shall apply.

(b) *Credit rate*. The Secretary shall determine monthly (or more often as deemed necessary by the Secretary) the credit rate the Secretary estimates will generally permit the issuance of a qualified zone academy bond without discount and without interest cost to the issuer. The manner for ascertaining the credit rate for a qualified zone academy bond as determined by the Secretary shall be set forth in procedures, notices, forms, or instructions prescribed by the Commissioner.

(c) *Private business contribution requirement*—(1) *Reasonable discount rate*. To determine the present value (as of the issue date) of qualified contributions from private entities under section 1397E(d)(2), the issuer must use a reasonable discount rate. The credit rate determined under paragraph (b) of this section is a reasonable discount rate.

(2) *Definition of private entities*. For purposes of section 1397E(d)(2)(A), the term *private entities* includes any person (as defined in section 7701(a)) other than the United States, a State or local government, or any agency or instrumentality thereof or related party with respect thereto. To determine whether a person is related to the United States or a State or local government under this paragraph (c)(2), rules similar to those for determining whether a person is a related party under § 1.150–1(b) shall apply (treating the United States as a governmental unit for purposes of § 1.150–1(b)).

(3) *Qualified contribution*. For purposes of section 1397E(d)(2)(A), the term *qualified contribution* means any contribution (of a type and quality acceptable to the eligible local education

agency) of any property or service described in section 1397E(d)(2)(B)(i), (ii), (iii), (iv) or (v). In addition, cash received with respect to a qualified zone academy from a private entity (other than cash received indirectly from a person that is not a private entity as part of a plan to avoid the requirements of section 1397E) constitutes a qualified contribution if it is to be used to purchase any property or service described in section 1397E(d)(2)(B)(i), (ii), (iii), (iv) or (v). Services of employees of the eligible local education agency do not constitute qualified contributions.

(d) *Maximum term.* The maximum term for a QZAB is determined under section 1397E(d)(3) by using a discount rate equal to 110 percent of the long-term adjusted applicable Federal rate (AFR), compounded semi-annually, for the month in which the bond is sold. The Internal Revenue Service publishes this figure each month in a revenue ruling that is published in the Internal Revenue Bulletin. See § 601.601(d)(2)(ii)(*b*) of this chapter. A bond is sold on the sale date, as defined in § 1.150–1(c)(6), which is the first day on which there is a binding contract in writing for the sale or exchange of the bond.

(e) *Tax credit*—(1) *Eligible taxpayer.* An eligible taxpayer (within the meaning of section 1397E(d)(6)) that holds a qualified zone academy bond on a credit allowance date is allowed a tax credit against the Federal income tax imposed on the taxpayer for the taxable year that includes the credit allowance date. The amount of the credit is equal to the product of the credit rate and the outstanding principal amount of the bond on the credit allowance date. The credit is subject to a limitation based on the eligible taxpayer's income tax liability. See section 1397E(c).

(2) *Ineligible taxpayer.* A taxpayer that is not an eligible taxpayer is not allowed a credit.

(f) *Treatment of the allowance of the credit as a payment of interest*—(1) *General rule.* The holder of a qualified zone academy bond must treat the bond as if it pays qualified stated interest (within the meaning of § 1.1273–1(c)) on each credit allowance date. The amount of the deemed payment of interest on each credit allowance date is equal to the product of the credit rate and the outstanding principal amount of the bond on that date. Thus, for example, if the holder uses an accrual method of accounting, the holder must accrue as interest income the amount of the credit over the one-year accrual period that ends on the credit allowance date.

(2) *Adjustment if the holder cannot use the credit to offset a tax liability.* If a holder holds a qualified zone academy bond on the credit allowance date but cannot use all or a portion of the credit to reduce its income tax liability (for example, because the holder is not an eligible taxpayer or because the limitation in section 1397E(c) applies), the holder is allowed a deduction for the taxable year that includes the credit allowance date (or, at the option of the holder, the next succeeding taxable year). The amount of the deduction is equal to the amount of the unused credit deemed paid on the credit allowance date.

(g) *Not a tax-exempt obligation.* A qualified zone academy bond is not an obligation the interest on which is excluded from gross income under section 103(a).

(h) *Use of proceeds*—(1) *In general.* Section 1397E(d)(1) provides that a bond issued as part of an issue is a QZAB only if, among other requirements, at least 95 percent of the proceeds of the issue are to be used for a qualified purpose with respect to a qualified zone academy established by an eligible local education agency (as defined in section 1397E(d)(4)(B)), and the issue meets the requirements of section 1397E(f) and (g). Section 1397E(d)(5) defines *qualified purpose,* with respect to any qualified zone academy, as rehabilitating or repairing the public school facility in which such academy is established, providing equipment for use at such academy, developing course materials for education to be provided at such academy, and training teachers and other school personnel in such academy. Section 1397E(d)(4)(A) defines *qualified zone academy* as any public school (or academic program within a public school) that is established by and operated under the supervision of an eligible local education agency to provide education or training below the

postsecondary level and that meets the requirements of section 1397E(d)(4)(A)(i), (ii), (iii) and (iv).

(2) *Use of proceeds requirements.* An issue meets the requirements of sections 1397E (d)(1)(A) and (f) only if—

(i) The issuer reasonably expects, as of the issue date of the issue, that—

(A) At least 95 percent of the proceeds from the sale of the issue are to be spent for qualified purposes with respect to qualified zone academies within the 5-year period beginning on the issue date of the QZAB;

(B) A binding commitment with a third party to spend at least 10 percent of the proceeds from the sale of the issue will be incurred within the 6-month period beginning on the issue date of the QZAB;

(C) At least 95 percent of the proceeds from the sale of the issue will be spent for qualified purposes with respect to a qualified zone academy with due diligence (with due diligence measured by the reasonableness standard under § 1.148–1(b)); and

(D) At least 95 percent of the proceeds of the issue will be used for qualified purposes with respect to a qualified zone academy for the entire term of the issue (without regard to any redemption provision); and

(ii) Except as otherwise provided in paragraph (h)(8) of this section, at least 95 percent of the proceeds of the issue are actually used for qualified purposes with respect to a qualified academy for the entire term of the issue (without regard to any redemption provision).

(3) *Extension of 5-year period.* The Commissioner may extend the period described in paragraph (h)(2)(i)(A) of this section if the issuer, prior to the end of such period, submits a private ruling request, and establishes to the satisfaction of the Commissioner that—

(i) The failure to satisfy the 5-year spending requirement is due to reasonable cause; and

(ii) The expenditure of at least 95 percent of the proceeds from the sale of the issue for a qualified purpose with respect to a qualified zone academy will continue to proceed with due diligence.

(4) *Unspent proceeds.* For purposes of paragraphs (h)(2)(i)(D) and (h)(2)(ii) of this section, during the period described in paragraph (h)(2)(i)(A) of this section, including any extension under paragraph (h)(3) of this section, unspent proceeds are treated as used for a qualified purpose with respect to a qualified zone academy if the issuer reasonably expects to proceed with due diligence to spend those proceeds for a qualified purpose with respect to a qualified zone academy during that period.

(5) *Proceeds spent for rehabilitation, repair or equipment*—(i) *In general.* Under section 1397E(d)(5)(A) the term *qualified purpose* with respect to any qualified zone academy includes rehabilitating or repairing the public school facility in which such academy is established. For this purpose, in determining whether proceeds are spent for rehabilitation, rules similar to those under section 47(c) (other than sections 47(c)(1)(B) and 47(c)(2)(B)(iv)) shall apply. Under section 1397E(d)(5)(B) the term *qualified purpose* also includes providing equipment for use at such academy. If proceeds of an issue are spent for a purpose described in section 1397E(d)(5)(A) or (B) with respect to a qualified zone academy, then those proceeds are treated as used for a qualified purpose with respect to the academy during any period after such expenditure that—

(A) The property financed with those proceeds is used for the purposes of the academy; and

(B) The academy maintains its status as a qualified zone academy under section 1397E(d)(4).

(ii) *Retirement from service.* The retirement from service of financed property due to normal wear or obsolescence does not cause the property to fail to be used for a qualified purpose with respect to a qualified zone academy.

(6) *Proceeds spent to develop course materials or train teachers.* Section 1397E(d)(5)(C) and (D) provides that the term *qualified purpose* with respect to any qualified zone academy includes developing course materials for education to be provided at such academy, and training teachers and other school personnel in such academy. If proceeds of an issue are spent for a purpose described in section 1397E(d)(5)(C) or (D)

with respect to a qualified zone academy, then those proceeds are treated as used for a qualified purpose with respect to the academy during any period after such expenditure.

(7) *Special rule for determining status as qualified zone academy.* Section 1397E(d)(4)(A)(iv) provides that a public school (or academic program within a public school) is a qualified zone academy only if, among other requirements, the public school is located in an empowerment zone or enterprise community (as defined in section 1393), or there is a reasonable expectation (as of the issue date of the issue) that at least 35 percent of the students attending the school or participating in the program (as the case may be) will be eligible for free or reduced-cost lunches under the school lunch program established under the Richard B. Russell National School Lunch Act. For purposes of determining whether an issue complies with section 1397E(d)(4)(A)(iv)—

(i) A public school is treated as located in an empowerment zone or enterprise community for the entire term of the issue if the public school is located in an empowerment zone or enterprise community on the issue date of the issue; and

(ii) The determination of whether there is a reasonable expectation (as of the issue date of the issue) that at least 35 percent of the students attending the school or participating in the program (as the case may be) will be eligible for free or reduced-cost lunches under the school lunch program established under the Richard B. Russell National School Lunch Act is based on expectations regarding the one-year period following the issue date.

(8) *Remedial actions*—(i) *General rule.* If less than 95 percent of the proceeds of an issue are properly used (as determined under paragraph (h)(8)(ii)(D) of this section), the issue will be treated as meeting the requirements of section 1397E(d)(1)(A) if the issue met the requirements of paragraph (h)(2)(i) of this section and a remedial action is taken under paragraph (h)(8)(ii) or (iii) of this section.

(ii) *Redemption or defeasance*—(A) *In general.* A remedial action is taken under this paragraph (h)(8)(ii) if the requirements of paragraphs (h)(8)(ii)(B) and (C) of this section are met.

(B) *Retirement of nonqualified bonds*—(*1*) *In general.* The requirements of this paragraph (h)(8)(ii)(B) are met if—

(*i*) All of the nonqualified bonds of the issue (as determined under § 1.142–2(e)) are redeemed within 90 days after the date on which the failure to properly use proceeds occurs; or

(*ii*) To the extent proceeds of the issue that have been actually spent for a qualified purpose with respect to a qualified zone academy, if any nonqualified bonds of the issue are not redeemed within 90 days after the date on which the failure to properly use such proceeds occurs (the unredeemed nonqualified bonds), a defeasance escrow is established for the unredeemed nonqualified bonds within 90 days after the date on which the failure to properly use proceeds occurs.

(*2*) *Special rule for dispositions for cash.* If the failure to properly use proceeds occurs because of a disposition of financed property described in section 1397E(d)(5)(A) or (B) and the consideration for the disposition is exclusively cash, the requirements of this paragraph (h)(8)(ii)(B) are met if all of the disposition proceeds (as defined in paragraph (h)(8)(iv) of this section) are used within 90 days after the date of the disposition to redeem, or establish a defeasance escrow for, the nonqualified bonds (as determined under § 1.142–2(e)).

(*3*) *Definition of defeasance escrow.* For purposes of this section, a defeasance escrow is an irrevocable escrow established to retire nonqualified bonds on the earliest call date after the date on which the failure to properly use proceeds occurs in an amount that is sufficient to retire nonqualified bonds on that call date. At least 90 percent of the weighted average amount in a defeasance escrow must be invested in investments (as defined in § 1.148–1(b)), except that no amount in a defeasance escrow may be invested in any investment the obligor (or any person that is a related party with respect to the obligor within the meaning of § 1.150–1(b)) of which is a user of proceeds of the bonds. All purchases or sales of an investment in a defeasance escrow must be made at the fair market value of the

investment within the meaning of § 1.148–5(d)(6).

(C) *Additional rules*—(*1*) *Limitation on source of funding*. Proceeds of an issue of QZABs (other than unspent proceeds of the issue for which the failure to properly use proceeds occurs) must not be used to redeem or defease nonqualified bonds under paragraph (h)(8)(ii)(B) of this section.

(*2*) *Rebate requirement*. The issuer must pay to the United States, at the same time and in the same manner as rebate amounts are required to be paid under § 1.148–3 (or at such other time or in such other manner as the Commissioner may prescribe), any investment earnings on amounts in a defeasance escrow established under paragraph (h)(8)(ii)(B) of this section that are in excess of the yield on the issue of QZABs with respect to which the defeasance escrow was established. For this purpose, the first computation period begins on the date on which the defeasance escrow is established.

(*3*) *Notice of defeasance*. The issuer must provide written notice to the Commissioner, at the place designated in § 1.150–5(a), of the establishment of the defeasance escrow within 90 days of the date the defeasance escrow is established.

(D) *When a failure to properly use proceeds occurs*—(*1*) *Unspent proceeds*. For unspent proceeds, a failure to properly use proceeds occurs on the earliest of—

(*i*) The first date on which the public school (or academic program within the public school) fails to constitute a qualified zone academy;

(*ii*) The first date on which the issuer fails to have a reasonable expectation to proceed with due diligence to spend at least 95 percent of the proceeds of the issue for a qualified purpose with respect to a qualified zone academy; or

(*iii*) The last day of the period described in paragraph (h)(2)(i)(A) of this section, including any extension, if less than 95 percent of the proceeds of the issue are actually spent for a qualified purpose with respect to a qualified zone academy.

(*2*) *Proceeds spent for rehabilitation, repair or equipment*. For proceeds that have been spent for a purpose described in section 1397E(d)(5)(A) or (B) with respect to a qualified zone academy, a failure to properly use proceeds occurs on the earlier of—

(*i*) The first date on which the public school (or academic program within the public school) fails to constitute a qualified zone academy; and

(*ii*) The first date on which an action is taken that causes the issuer to fail actually to use at least 95 percent of the proceeds of the issue for a qualified purpose with respect to a qualified zone academy.

(*3*) *Proceeds spent for course materials or training*. If proceeds have been spent for a purpose described in section 1397E(d)(5)(C) or (D) with respect to a qualified zone academy, no event subsequent to such expenditure shall constitute a failure to properly use such proceeds.

(iii) *Alternative use of disposition proceeds*. A remedial action is taken under this paragraph (h)(8)(iii) if all of the requirements of paragraphs (h)(8)(iii)(A) through (D) of this section are met—

(A) The failure to properly use proceeds (as determined under paragraph (h)(8)(ii)(D) of this section) is a disposition of financed property described in section 1397E(d)(5)(A) or (B) and the consideration for the disposition is exclusively cash;

(B) The issuer reasonably expects as of the date of the disposition that—

(*1*) All of the disposition proceeds will be spent within the two-year period beginning with the date of the disposition for a qualified purpose with respect to a qualified zone academy; or

(*2*) To the extent not expected to be so spent, the disposition proceeds will be used within 90 days after the date of the disposition to redeem or defease bonds in a manner that meets the requirements of paragraph (h)(8)(ii) of this section;

(C) The disposition proceeds are treated as proceeds for purposes of section 1397E; and

(D) If all of the disposition proceeds are not actually used in the manner described in paragraph (h)(8)(iii)(B) of this section, the remainder of such amounts are used within 90 days after the end of the period described in paragraph (h)(8)(iii)(B)(*1*) of this section for a remedial action that meets the requirements of paragraph (h)(8)(ii) of this section.

(iv) *Definition of disposition proceeds and allocation among multiple funding sources.* For purposes of this paragraph (h)(8), *disposition proceeds* means disposition proceeds, as defined in § 1.141–12(c)(1), plus amounts derived from investing disposition proceeds. If property has been financed with an issue of QZABs and one or more other funding sources, any disposition proceeds from that property are allocated to the issue under the principles of § 1.141–12(c)(3).

(9) *Payment of principal, interest or redemption price*—(i) *In general.* Except as provided in paragraphs (h)(9)(ii) and (h)(9)(iii) of this section, the use of proceeds of a bond to pay principal, interest, or redemption price of the bond or another bond is not a qualified purpose within the meaning of section 1397E(d)(5).

(ii) *Exception for certain eligible reimbursements of interim refinancings.* The use of proceeds of a bond (the refinancing bond) to pay principal, interest, or redemption price of another bond (the prior bond) is a qualified purpose within the meaning of section 1397E(d)(5) to the extent that—

(A) The prior bond was not a QZAB (and, in the case of a series of refinancings, no earlier bond in the series was a QZAB);

(B) The proceeds of the prior bond (or the original bond in the case of a series of refinancings, as applicable) were spent for a qualified purpose under section 1397E(d)(5) with respect to a qualified zone academy (the original expenditure); and

(C) The issuer makes a valid reimbursement allocation to allocate the proceeds of the refinancing bond to the payment of the original expenditure (the reimbursement allocation), which allocation satisfies the requirements for reimbursements under paragraph (h)(10) of this section. For purposes of applying the rules for reimbursement, a refinancing bond which otherwise meets the requirements of this paragraph (h)(9)(ii) is eligible for reimbursement and is not treated as a disqualified refunding under § 1.150–2(g).

(iii) *Reissuance of a QZAB.* For purposes of determining whether the establishing of a defeasance escrow under paragraph (h)(8)(ii)(B)(*1*)(*ii*) of this section results in an exchange under § 1.1001–1(a), the QZAB is treated as a tax-exempt bond under § 1.1001–3(e)(5)(ii)(B)(*1*).

(10) *Reimbursement.* An expenditure for a qualified purpose may be reimbursed with proceeds of a QZAB. For this purpose, rules similar to those on reimbursement of expenditures in § 1.142–4(b) and § 1.150–2 shall apply. In applying these reimbursement rules, expenditures eligible for reimbursement under § 1.150–2(d)(3) shall be deemed to mean any expenditure for a qualified purpose under section 1397E(d)(5).

(i) *Arbitrage investment restrictions*—(1) *In general.* Under section 1397E(g) and this paragraph (i), and except as otherwise provided in this paragraph (i), the arbitrage investment restrictions and rebate requirements under section 148 and §§ 1.148–1 through 1.148–11, inclusive, and the exceptions to those restrictions, apply broadly to gross proceeds of QZABs issued under section 1397E to the same extent and in the same manner as they apply to gross proceeds of tax-exempt state or local governmental bonds. For this purpose, references in those sections to tax-exempt bonds generally shall be deemed to refer to QZABs and, to the extent that any particular arbitrage restriction depends on whether bonds are private activity bonds under section 141, the determination of whether QZABs are private activity bonds shall be based on the general definition of private activity bonds under section 141. In applying section 148 and the regulations under that section to QZABs, the modifications set forth in paragraphs (i)(2) through (i)(6) of this section shall apply.

(2) *5-year temporary period exception to arbitrage yield restriction.* If an issue of QZABs meets the requirements of section 1397E(f)(1) and paragraph (h)(2)(i) of this section, then the proceeds of the issue of QZABs are treated as qualifying for a 5-year temporary period exception to arbitrage yield restriction under § 1.148–2(e)(2) beginning on the issue date of the issue.

(3) *Disregard QZAB credit in QZAB yield for arbitrage purposes.* In determining the yield on an issue of QZABs for arbitrage purposes under § 1.148–4,

the QZAB credit allowed under section 1397E(a) is disregarded.

(4) *Non-AMT tax-exempt bond investment exception inapplicable.* The exception to arbitrage yield restriction for investments of gross proceeds of tax-exempt bonds in specified tax-exempt bond investments not subject to section 148(b)(3)(B) (relating to an exception to the definition of ''investment property'' for specified tax-exempt bonds) and §1.148–2(d)(2)(v) (relating to a corresponding exception to arbitrage yield limitations) is inapplicable.

(5) *Application of small issuer exception to the arbitrage rebate requirement.* Except as otherwise provided in paragraph (i)(6) of this section, for purposes of the small issuer exception to the arbitrage rebate requirement under section 148(f)(4)(D) and §1.148–8, QZABs that are actually issued or reasonably expected to be issued by the QZAB issuer (and applicable entities aggregated under section 148(f)(4)(D)) within a calendar year are taken into account in measuring the applicable size limitation.

(6) *Certain defeasance escrow earnings.* With respect to a defeasance escrow established in a remedial action for an issue of QZABs that meets the special rebate requirement under paragraph (h)(8)(ii)(C)(*2*) of this section, the QZAB issuer is treated as ineligible for the small issuer exception to arbitrage rebate under section 148(f)(4)(D) and paragraph (i)(5) of this section and compliance with that special rebate requirement is treated as satisfying applicable arbitrage investment restrictions under section 148 for that defeasance escrow.

(j) *Information reporting requirement.* Under section 1397E(h) and this paragraph (j), issuers of QZABs are required to submit information reporting returns to the IRS similar to the information reporting returns required to be submitted to the IRS under section 149(e) for tax-exempt state or local governmental bonds at the same time and in the same manner as those reports are required to be submitted to the IRS on such forms as shall be prescribed by the Commissioner for such purpose.

(k) *State or local government*—(1) *In general.* For purposes of section 1397E(d)(1)(B), the term *State or local government* means a State or political subdivision as defined for purposes of section 103(c).

(2) *On behalf of issuer.* A qualified zone academy bond may be issued on behalf of a State or local government under rules similar to those for determining whether a bond issued on behalf of a State or political subdivision constitutes an obligation of that State or political subdivision for purposes of section 103.

(l) *Cross-references.* See section 171 and the regulations thereunder for rules relating to amortizable bond premium. See §1.61–7(d) for the seller's treatment of a bond sold between interest payment dates (credit allowance dates) and §1.61–7(c) for the buyer's treatment of a bond purchased between interest payment dates (credit allowance dates).

(m) *Effective/applicability dates*—(1) *In general.* Except as otherwise provided in this paragraph (m), this section applies to bonds issued under section 1397E that are sold on or after September 14, 2007.

(2) *Special effective dates*—(i) *Effective dates for paragraphs (h)(2), (h)(3), (h)(4), (i), and (j) of this section in general.* Paragraphs (h)(2), (h)(3), (h)(4), (i), and (j) of this section apply to bonds issued under section 1397E pursuant to allocations of the national qualified zone academy bond volume cap authority for calendar years after 2005 and sold on or after September 14, 2007.

(ii) *Permissive retroactive application*—(A) *In general.* Except as otherwise provided in this paragraph (m), issuers and taxpayers may apply this section in whole, but not in part, to bonds issued under section 1397E that are sold before September 14, 2007.

(B) *Special rule for certain provisions.* For purposes of the permissive retroactive application rule in paragraph (m)(2)(ii)(A) of this section, paragraphs (h)(2), (h)(3), (h)(4), (i), and (j) of this section need not be applied to any bonds issued under section 1397E to which those provisions do not otherwise apply under the general effective date provisions for those provisions in paragraph (m)(2)(i) of this section.

(C) *Definition of proceeds.* Issuers and taxpayers may apply paragraph (h) of

this section, without regard to the definition of proceeds in paragraph (a)(2)(ii) of this section, to bonds issued under section 1397E that are sold before September 14, 2007.

(D) *Bonds issued before July 1, 1999.* Paragraphs (b) and (h)(10) of this section may not be applied to bonds issued under section 1397E that are issued before July 1, 1999.

(3) *Scope of reliance for bonds issued under sections 54A and 54E.* Except to the extent inconsistent with the successor statutory provisions for QZABs in sections 54A and 54E or applicable public administrative or regulatory guidance under those provisions and except as otherwise provided in this paragraph (m)(3), issuers and taxpayers may apply these regulations to QZABs issued under sections 54A and 54E that are sold after October 3, 2008. In the case of QZABs that are issued under sections 54A and 54E for which the issuer makes an irrevocable election under section 6431(f) to receive payments with respect to credits under section 6431, issuers and taxpayers may not apply the remedial action provisions under paragraph (h)(8) of this section.

[T.D. 8755, 63 FR 673, Jan. 7, 1998; 63 FR 8528, Feb. 19, 1998, as amended by T.D. 8826, 64 FR 35574, July 1, 1999. Redesignated and amended by T.D. 8903, 65 FR 57733, Sept. 26, 2000; T.D. 9339, 72 FR 38774, July 16, 2007;T.D. 9495, 75 FR 44904, July 30, 2010; T.D. 9495, 75 FR 52267, Aug. 25, 2010]

RULES RELATING TO INDIVIDUALS' TITLE 11 CASES

SOURCE: Sections 1.1398–1 and 1.1398–2 appear at T.D. 8537, 59 FR 24937, May 13, 1994, unless otherwise noted.

§ 1.1398–1 Treatment of passive activity losses and passive activity credits in individuals' title 11 cases.

(a) *Scope.* This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) *Definitions and rules of general application.* For purposes of this section—

(1) *Passive activity* and *former passive activity* have the meanings given in section 469 (c) and (f)(3);

(2) The unused passive activity loss (determined as of the first day of a taxable year) is the passive activity loss (as defined in section 469(d)(1)) that is disallowed under section 469 for the previous taxable year; and

(3) The unused passive activity credit (determined as of the first day of a taxable year) is the passive activity credit (as defined in section 469(d)(2)) that is disallowed under section 469 for the previous taxable year.

(c) *Estate succeeds to losses and credits upon commencement of case.* The bankruptcy estate (estate) succeeds to and takes into account, beginning with its first taxable year, the debtor's unused passive activity loss and unused passive activity credit (determined as of the first day of the debtor's taxable year in which the case commences).

(d) *Transfers from estate to debtor*—(1) *Transfer not treated as taxable event.* If, before the termination of the estate, the estate transfers an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange), the transfer is not treated as a disposition for purposes of any provision of the Internal Revenue Code assigning tax consequences to a disposition. The transfers to which this rule applies include transfers from the estate to the debtor of property that is exempt under section 522 of title 11 of the United States Code and abandonments of estate property to the debtor under section 554(a) of such title.

(2) *Treatment of passive activity loss and credit.* If, before the termination of the estate, the estate transfers an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange)—

(i) The estate must allocate to the transferred interest, in accordance with § 1.469–1(f)(4), part or all of the estate's unused passive activity loss and unused passive activity credit (determined as of the first day of the estate's taxable year in which the transfer occurs); and

(ii) The debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the transfer occurs, the unused passive activity loss and unused passive activity credit (or part thereof) allocated to the transferred interest.

(e) *Debtor succeeds to loss and credit of the estate upon its termination.* Upon termination of the estate, the debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the termination occurs, the passive activity loss and passive activity credit disallowed under section 469 for the estate's last taxable year.

(f) *Effective date*—(1) *Cases commencing on or after November 9, 1992.* This section applies to cases commencing on or after November 9, 1992.

(2) *Cases commencing before November 9, 1992*—(i) *Election required.* This section applies to a case commencing before November 9, 1992, and terminating on or after that date if the debtor and the estate jointly elect its application in the manner prescribed in paragraph (f)(2)(v) of this section (the election). The caption ''ELECTION PURSUANT TO §1.1398–1'' must be placed prominently on the first page of each of the debtor's returns that is affected by the election (other than returns for taxable years that begin after the termination of the estate) and on the first page of each of the estate's returns that is affected by the election. In the case of returns that are amended under paragraph (f)(2)(iii) of this section, this requirement is satisfied by placing the caption on the amended return.

(ii) *Scope of election.* This election applies to the passive and former passive activities and unused passive activity losses and passive activity credits of the taxpayers making the election.

(iii) *Amendment of previously filed returns.* The debtor and the estate making the election must amend all returns (except to the extent they are for a year that is a closed year within the meaning of paragraph (f)(2)(iv)(D) of this section) they filed before the date of the election to the extent necessary to provide that no claim of a deduction or credit is inconsistent with the succession under this section to unused losses and credits. The Commissioner may revoke or limit the effect of the election if either the debtor or the estate fails to satisfy the requirement of this paragraph (f)(2)(iii).

(iv) *Rules relating to closed years*—(A) Estate succeeds to debtor's passive activity loss and credit as of the commencement date. If, by reason of an election under this paragraph (f), this section applies to a case that was commenced in a closed year, the estate, nevertheless, succeeds to and takes into account the unused passive activity loss and unused passive activity credit of the debtor (determined as of the first day of the debtor's taxable year in which the case commenced).

(B) *No reduction of unused passive activity loss and credit for passive activity loss and credit not claimed for a closed year.* In determining a taxpayer's carryover of a passive activity loss or credit to its taxable year following a closed year, a deduction or credit that the taxpayer failed to claim in the closed year, if attributable to an unused passive activity loss or credit to which the taxpayer succeeded under this section, is treated as a deduction or credit that was disallowed under section 469.

(C) *Passive activity loss and credit to which taxpayer succeeds reflects deductions of prior holder in a closed year.* A loss or credit to which a taxpayer would otherwise succeed under this section is reduced to the extent the loss or credit was allowed to its prior holder for a closed year.

(D) *Closed year.* For purposes of this paragraph (f)(2)(iv), a taxable year is closed to the extent the assessment of a deficiency or refund of an overpayment is prevented, on the date of the election and at all times thereafter, by any law or rule of law.

(v) *Manner of making election*—(A) *Chapter 7 cases.* In a case under chapter 7 of title 11 of the United States Code, the election is made by obtaining the written consent of the bankruptcy trustee and filing a copy of the written consent with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(B) *Chapter 11 cases.* In a case under chapter 11 of title 11 of the United States Code, the election is made by incorporating the election into a bankruptcy plan that is confirmed by the bankruptcy court or into an order of such court and filing the pertinent portion of the plan or order with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(vi) *Election is binding and irrevocable.* Except as provided in paragraph (f)(2)(iii) of this section, the election, once made, is binding on both the debtor and the estate and is irrevocable.

§ 1.1398–2 Treatment of section 465 losses in individuals' title 11 cases.

(a) *Scope.* This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) *Definition and rules of general application.* For purposes of this section—

(1) *Section 465 activity* means an activity to which section 465 applies; and

(2) For each section 465 activity, the unused section 465 loss from the activity (determined as of the first day of a taxable year) is the loss (as defined in section 465(d)) that is not allowed under section 465(a)(1) for the previous taxable year.

(c) *Estate succeeds to losses upon commencement of case.* The bankruptcy estate (the estate) succeeds to and takes into account, beginning with its first taxable year, the debtor's unused section 465 losses (determined as of the first day of the debtor's taxable year in which the case commences).

(d) *Transfers from estate to debtor*—(1) *Transfer not treated as taxable event.* If, before the termination of the estate, the estate transfers an interest in a section 465 activity to the debtor (other than by sale or exchange), the transfer is not treated as a disposition for purposes of any provision of the Internal Revenue Code assigning tax consequences to a disposition. The transfers to which this rule applies include transfers from the estate to the debtor of property that is exempt under section 522 of title 11 of the United States Code and abandonments of estate property to the debtor under section 554(a) of such title.

(2) *Treatment of section 465 losses.* If, before the termination of the estate, the estate transfers an interest in a section 465 activity to the debtor (other than by sale or exchange) the debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the transfer occurs, the transferred interest's share of the estate's unused section 465 loss from the activity (determined as of the first day of the estate's taxable year in which the transfer occurs). For this purpose, the transferred interest's share of such loss is the amount, if any, by which such loss would be reduced if the transfer had occurred as of the close of the preceding taxable year of the estate and been treated as a disposition on which gain or loss is recognized.

(e) *Debtor succeeds to losses of the estate upon its termination.* Upon termination of the estate, the debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the termination occurs, the losses not allowed under section 465 for the estate's last taxable year.

(f) *Effective date*—(1) *Cases commencing on or after November 9, 1992.* This section applies to cases commencing on or after November 9, 1992.

(2) *Cases commencing before November 9, 1992*—(i) *Election required.* This section applies to a case commencing before November 9, 1992, and terminating on or after that date if the debtor and the estate jointly elect its application in the manner prescribed in paragraph (f)(2)(v) of this section (the election). The caption ''ELECTION PURSUANT TO § 1.1398–2'' must be placed prominently on the first page of each of the debtor's returns that is affected by the election (other than returns for taxable years that begin after the termination of the estate) and on the first page of each of the estate's returns that is affected by the election. In the case of returns that are amended under paragraph (f)(2)(iii) of this section, this requirement is satisfied by placing the caption on the amended return.

(ii) *Scope of election.* This election applies to the section 465 activities and unused losses from section 465 activities of the taxpayers making the election.

(iii) *Amendment of previously filed returns.* The debtor and the estate making the election must amend all returns (except to the extent they are for a year that is a closed year within the meaning of paragraph (f)(2)(iv)(D) of this section) they filed before the date of the election to the extent necessary to provide that no claim of a deduction is inconsistent with the succession under this section to unused losses

from section 465 activities. The Commissioner may revoke or limit the effect of the election if either the debtor or the estate fails to satisfy the requirement of this paragraph (f)(2)(iii).

(iv) *Rules relating to closed years*—(A) *Estate succeeds to debtor's section 465 loss as of the commencement date.* If, by reason of an election under this paragraph (f), this section applies to a case that was commenced in a closed year, the estate, nevertheless, succeeds to and takes into account the section 465 losses of the debtor (determined as of the first day of the debtor's taxable year in which the case commenced).

(B) *No reduction of unused section 465 loss for loss not claimed for a closed year.* In determining a taxpayer's carryover of an unused section 465 loss to its taxable year following a closed year, a deduction that the taxpayer failed to claim in the closed year, if attributable to an unused section 465 loss to which the taxpayer succeeds under this section, is treated as a deduction that was not allowed under section 465.

(C) *Loss to which taxpayer succeeds reflects deductions of prior holder in a closed year.* A loss to which a taxpayer would otherwise succeed under this section is reduced to the extent the loss was allowed to its prior holder for a closed year.

(D) *Closed year.* For purposes of this paragraph (f)(2)(iv), a taxable year is closed to the extent the assessment of a deficiency or refund of an overpayment is prevented, on the date of the election and at all times thereafter, by any law or rule of law.

(v) *Manner of making election*—(A) *Chapter 7 cases.* In a case under chapter 7 of title 11 of the United States Code, the election is made by obtaining the written consent of the bankruptcy trustee and filing a copy of the written consent with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(B) *Chapter 11 cases.* In a case under chapter 11 of title 11 of the United States Code, the election is made by incorporating the election into a bankruptcy plan that is confirmed by the bankruptcy court or into an order of such court and filing the pertinent portion of the plan or order with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(vi) *Election is binding and irrevocable.* Except as provided in paragraph (f)(2)(iii) of this section, the election, once made, is binding on both the debtor and the estate and is irrevocable.

§ 1.1398–3 Treatment of section 121 exclusion in individuals' title 11 cases.

(a) *Scope.* This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) *Definition and rules of general application.* For purposes of this section, section 121 exclusion means the exclusion of gain from the sale or exchange of a debtor's principal residence available under section 121.

(c) *Estate succeeds to exclusion upon commencement of case.* The bankruptcy estate succeeds to and takes into account the section 121 exclusion with respect to the property transferred into the estate.

(d) *Effective date.* This section is applicable for sales or exchanges on or after December 24, 2002.

[67 FR 78367, Dec. 24, 2002]

§ 1.1400L(b)–1 Additional first year depreciation deduction for qualified New York Liberty Zone property.

(a) *Scope.* This section provides the rules for determining the 30-percent additional first year depreciation deduction allowable under section 1400L(b) for qualified New York Liberty Zone property.

(b) *Definitions.* For purposes of section 1400L(b) and this section, the definitions of the terms in § 1.168(k)–1(a)(2) apply and the following definitions also apply:

(1) *Building* and *structural components* have the same meanings as those terms are defined in § 1.48–1(e).

(2) *New York Liberty Zone* is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York.

(3) *Nonresidential real property* and *residential rental property* have the same

meanings as those terms are defined in section 168(e)(2).

(4) *Real property* is a building or its structural components, or other tangible real property.

(c) *Qualified New York Liberty Zone property*—(1) *In general.* Qualified New York Liberty Zone property is depreciable property that meets all the following requirements in the first taxable year in which the property is subject to depreciation by the taxpayer whether or not depreciation deductions for the property are allowable—

(i) The requirements in §1.1400L(b)–1(c)(2) (description of property);

(ii) The requirements in §1.1400L(b)–1(c)(3) (substantial use);

(iii) The requirements in §1.1400L(b)–1(c)(4) (original use);

(iv) The requirements in §1.1400L(b)–1(c)(5) (acquisition of property by purchase); and

(v) The requirements in §1.1400L(b)–1(c)(6) (placed-in-service date).

(2) *Description of qualified New York Liberty Zone property*—(i) *In general.* Depreciable property will meet the requirements of this paragraph (c)(2) if the property is—

(A) Described in §1.168(k)–1(b)(2)(i); or

(B) Nonresidential real property or residential rental property depreciated under section 168, but only to the extent it rehabilitates real property damaged, or replaces real property destroyed or condemned, as a result of the terrorist attacks of September 11, 2001. Property is treated as replacing destroyed or condemned property if, as part of an integrated plan, the property replaces real property that is included in a continuous area that includes real property destroyed or condemned. For purposes of this section, real property is considered as destroyed or condemned only if an entire building or structure was destroyed or condemned as a result of the terrorist attacks of September 11, 2001. Otherwise, the real property is considered damaged real property. For example, if certain structural components (for example, walls, floors, and plumbing fixtures) of a building are damaged or destroyed as a result of the terrorist attacks of September 11, 2001, but the building is not destroyed or condemned, then only costs related to replacing the damaged or destroyed structural components qualify under this paragraph (c)(2)(i)(B).

(ii) *Property not eligible for additional first year depreciation deduction.* Depreciable property will not meet the requirements of this paragraph (c)(2) if—

(A) Section 168(k) or §1.168(k)–1 applies to the property;

(B) The property is described in section 168(f);

(C) The property is required to be depreciated under the alternative depreciation system of section 168(g) pursuant to section 168(g)(1)(A) through (D) or other provisions of the Internal Revenue Code (for example, property described in section 263A(e)(2)(A) if the taxpayer (or any related person) has made an election under section 263A(d)(3), or property described in section 280F(b)(1));

(D) The property is included in any class of property for which the taxpayer elects not to deduct the additional first year depreciation under paragraph (e) of this section; or

(E) The property is qualified New York Liberty Zone leasehold improvement property as described in section 1400L(c)(2).

(3) *Substantial use.* Depreciable property will meet the requirements of this paragraph (c)(3) if substantially all of the use of the property is in the New York Liberty Zone and is in the active conduct of a trade or business by the taxpayer in New York Liberty Zone. For purposes of this paragraph (c)(3), ''substantially all'' means 80 percent or more.

(4) *Original use.* Depreciable property will meet the requirements of this paragraph (c)(4) if the original use of the property commences with the taxpayer in the New York Liberty Zone after September 10, 2001. The original use rules in §1.168(k)–1(b)(3) apply for purposes of this paragraph (c)(4). In addition, used property will satisfy the original use requirement in this paragraph (c)(4) so long as the property has not been previously used within the New York Liberty Zone.

(5) *Acquisition of property by purchase*—(i) *In general.* Depreciable property will meet the requirements of this paragraph (c)(5) if the property is acquired by the taxpayer by purchase (as

defined in section 179(d) and §1.179–4(c)) after September 10, 2001, but only if no written binding contract for the acquisition of the property was in effect before September 11, 2001. For purposes of this paragraph (c)(5), the rules in §1.168(k)–1(b)(4)(ii) (binding contract), the rules in §1.168(k)–1(b)(4)(iii) (self-constructed property), and the rules in §1.168(k)–1(b)(4)(iv) (disqualified transactions) apply. For purposes of the preceding sentence, the rules in §1.168(k)–1(b)(4)(iii) shall be applied without regard to 'and before January 1, 2005.'

(ii) *Exception for certain transactions.* For purposes of this section, the new partnership of a transaction described in §1.168(k)–1(f)(1)(ii) (technical termination of a partnership) or the transferee of a transaction described in §1.168(k)–1(f)(1)(iii) (section 168(i)(7) transactions) is deemed to acquire the depreciable property by purchase.

(6) *Placed-in-service date.* Depreciable property will meet the requirements of this paragraph (c)(6) if the property is placed in service by the taxpayer on or before December 31, 2006. However, nonresidential real property and residential rental property described in paragraph (c)(2)(i)(B) of this section must be placed in service by the taxpayer on or before December 31, 2009. The rules in §1.168(k)–1(b)(5)(ii) (relating to sale-leaseback and syndication transactions), the rules in §1.168(k)–1(b)(5)(iii) (relating to a technical termination of a partnership under section 708(b)(1)(B)), and the rules in §1.168(k)–1(b)(5)(iv) (relating to section 168(i)(7) transactions) apply for purposes of this paragraph (c)(6).

(d) *Computation of depreciation deduction for qualified New York Liberty Zone property.* The computation of the allowable additional first year depreciation deduction and the otherwise allowable depreciation deduction for qualified New York Liberty Zone property is made in accordance with the rules for qualified property in §1.168(k)–1(d)(1)(i) and (2).

(e) *Election not to deduct additional first year depreciation*—(1) *In general.* A taxpayer may make an election not to deduct the 30-percent additional first year depreciation for any class of property that is qualified New York Liberty Zone property placed in service during the taxable year. If a taxpayer makes an election under this paragraph (e), the election applies to all qualified New York Liberty Zone property that is in the same class of property and placed in service in the same taxable year, and no additional first year depreciation deduction is allowable for the class of property.

(2) *Definition of class of property.* For purposes of this paragraph (e), the term class of property means—

(i) Except for the property described in paragraphs (e)(2)(ii), (iv), and (v) of this section, each class of property described in section 168(e) (for example, 5-year property);

(ii) Water utility property as defined in section 168(e)(5) and depreciated under section 168;

(iii) Computer software as defined in, and depreciated under, section 167(f)(1) and the regulations thereunder;

(iv) Nonresidential real property as defined in paragraph (b)(3) of this section and as described in paragraph (c)(2)(B) of this section; or

(v) Residential rental property as defined in paragraph (b)(3) of this section and as described in paragraph (c)(2)(B) of this section

(3) *Time and manner for making election*—(i) *Time for making election.* Except as provided in paragraph (e)(4) of this section, the election specified in paragraph (e)(1) of this section must be made by the due date (including extensions) of the Federal tax return for the taxable year in which the qualified New York Liberty Zone property is placed in service by the taxpayer

(ii) *Manner of making election.* Except as provided in paragraph (e)(4) of this section, the election specified in paragraph (e)(1) of this section must be made in the manner prescribed on Form 4562, ''Depreciation and Amortization,'' and its instructions. The election is made separately by each person owning qualified New York Liberty Zone property (for example, for each member of a consolidated group by the common parent of the group, by the partnership, or by the S corporation). If Form 4562 is revised or renumbered, any reference in this section to that form shall be treated as a reference to the revised or renumbered form.

(4) *Special rules for 2000 or 2001 returns.* For the election specified in paragraph (e)(1) of this section for qualified New York Liberty Zone property placed in service by the taxpayer during the taxable year that included September 11, 2001, the taxpayer should refer to the guidance provided by the Internal Revenue Service for the time and manner of making this election on the 2000 or 2001 Federal tax return for the taxable year that included September 11, 2001 (for further guidance, *see* sections 3.03(3) and 4 of Rev. Proc. 2002–33 (2002–1 C.B. 963), Rev. Proc. 2003–50 (2003–29 I.R.B. 119), and §601.601(d)(2)(ii)(*b*) of this chapter).

(5) *Failure to make election.* If a taxpayer does not make the election specified in paragraph (e)(1) of this section within the time and in the manner prescribed in paragraph (e)(3) or (e)(4) of this section, the amount of depreciation allowable for that property under section 167(f)(1) or under section 168, as applicable, must be determined for the placed-in-service year and for all subsequent taxable years by taking into account the additional first year depreciation deduction. Thus, the election specified in paragraph (e)(1) of this section shall not be made by the taxpayer in any other manner (for example, the election cannot be made through a request under section 446(e) to change the taxpayer's method of accounting).

(6) *Alternative minimum tax.* If a taxpayer makes an election under this paragraph (e) for a class of property, the depreciation adjustments under section 56 and the regulations under section 56 apply to the property to which the election applies for purposes of computing the taxpayer's alternative minimum taxable income.

(7) *Revocation of election*—(i) *In general.* Except as provided in paragraph (e)(7)(ii) of this section, an election under this paragraph (e), once made, may be revoked only with the written consent of the Commissioner of Internal Revenue. To seek the Commissioner's consent, the taxpayer must submit a request for a letter ruling.

(ii) *Automatic 6-month extension.* If a taxpayer made an election under this paragraph (e) for a class of property, an automatic extension of 6 months from the due date of the taxpayer's Federal tax return (excluding extensions) for the placed-in-service year of the class of property is granted to revoke that election, provided the taxpayer timely filed the taxpayer's Federal tax return for the placed-in-service year of the class of property and, within this 6-month extension period, the taxpayer (and all taxpayers whose tax liability would be affected by the election) files an amended Federal tax return for the placed-in-service year of the class of property in a manner that is consistent with the revocation of the election.

(f) *Special rules*—(1) *Property placed in service and disposed of in the same taxable year.* Rules similar to those provided in §1.168(k)–1(f)(1) apply for purposes of this paragraph (f)(1).

(2) *Redetermination of basis.* If the unadjusted depreciable basis (as defined in §1.168(k)–1(a)(2)(iii)) of qualified New York Liberty Zone property is redetermined (for example, due to contingent purchase price or discharge of indebtedness) on or before December 31, 2006 (or on or before December 31, 2009, for nonresidential real property and residential rental property described in paragraph (c)(2)(i)(B) of this section), the additional first year depreciation deduction allowable for the qualified New York Liberty Zone property is redetermined in accordance with the rules provided in §1.168(k)–1(f)(2).

(3) *Section 1245 and 1250 depreciation recapture.* The rules provided in §1.168(k)–1(f)(3) apply for purposes of this paragraph (f)(3).

(4) *Coordination with section 169.* Rules similar to those provided in §1.168(k)–1(f)(4) apply for purposes of this paragraph (f)(4).

(5) *Like-kind exchanges and involuntary conversions.* This paragraph (f)(5) applies to acquired MACRS property (as defined in §1.168(k)–1(f)(5)(ii)(A)) or acquired computer software (as defined in §1.168(k)–1(f)(5)(ii)(C)) that is eligible for the additional first year depreciation deduction under section 1400L(b) at the time of replacement provided the time of replacement is after September 10, 2001, and on or before December 31, 2006, or in the case of acquired MACRS property or acquired computer software that is qualified New York Liberty Zone property described in paragraph (c)(2)(i)(B) of this

section, the time of replacement is after September 10, 2001, and on or before December 31, 2009. The rules and definitions similar to those provided in §1.168(k)–1(f)(5) apply for purposes of this paragraph (f)(5).

(6) *Change in use.* Rules similar to those provided in §1.168(k)–1(f)(6) apply for purposes of this paragraph (f)(6).

(7) *Earnings and profits.* The rule provided in §1.168(k)–1(f)(7) applies for purposes of this paragraph (f)(7).

(8) *Section 754 election.* Rules similar to those provided in §1.168(k)–1(f)(9) apply for purposes of this paragraph (f)(8).

(9) *Coordination with section 47.* Rules similar to those provided in §1.168(k)–1(f)(10) apply for purposes of this paragraph (f)(9).

(10) *Coordination with section 514(a)(3).* Rules similar to those provided in §1.168(k)–1(f)(11) apply for purposes of this paragraph (f)(10).

(g) *Effective date*—(1)*In general.* Except as provided in paragraphs (g)(2), (3), and (5) of this section, this section applies to qualified New York Liberty Zone property acquired by a taxpayer after September 10, 2001.

(2) *Technical termination of a partnership or section 168(i)(7) transactions.* If qualified New York Liberty Zone property is transferred in a technical termination of a partnership under section 708(b)(1)(B) or in a transaction described in section 168(i)(7) for a taxable year ending on or before September 8, 2003, and the additional first year depreciation deduction allowable for the property was not determined in accordance with paragraph (f)(1) of this section, the Internal Revenue Service will allow any reasonable method of determining the additional first year depreciation deduction allowable for the property in the year of the transaction that is consistently applied to the property by all parties to the transaction.

(3) *Like-kind exchanges and involuntary conversions.* If a taxpayer did not claim on a federal tax return for a taxable year ending on or before September 8, 2003, the additional first year depreciation deduction for the remaining carryover basis of qualified New York Liberty Zone property acquired in a transaction described in section 1031(a), (b), or (c), or in a transaction to which section 1033 applies and the taxpayer did not make an election not to deduct the additional first year depreciation deduction for the class of property applicable to the remaining carryover basis, the Internal Revenue Service will treat the taxpayer's method of not claiming the additional first year depreciation deduction for the remaining carryover basis as a permissible method of accounting and will treat the amount of the additional first year depreciation deduction allowable for the remaining carryover basis as being equal to zero, provided the taxpayer does not claim the additional first year depreciation deduction for the remaining carryover basis in accordance with paragraph (g)(4)(ii) of this section.

(4) *Change in method of accounting*—(i) *Special rules for 2000 or 2001 returns.* If a taxpayer did not claim on the federal tax return for the taxable year that included September 11, 2001, any additional first year depreciation deduction for a class of property that is qualified New York Liberty Zone property and did not make an election not to deduct the additional first year depreciation deduction for that class of property, the taxpayer should refer to the guidance provided by the Internal Revenue Service for the time and manner of claiming the additional first year depreciation deduction for the class of property (for further guidance, *see* section 4 of Rev. Proc. 2002–33 (2002–1 C.B. 963), Rev. Proc. 2003–50 (2003–29 I.R.B. 119), and §601.601(d)(2)(ii)(*b*) of this chapter).

(ii) *Like-kind exchanges and involuntary conversions.* If a taxpayer did not claim on a federal tax return for any taxable year ending on or before September 8, 2003, the additional first year depreciation deduction allowable for the remaining carryover basis of qualified New York Liberty Zone property acquired in a transaction described in section 1031(a), (b), or (c), or in a transaction to which section 1033 applies and the taxpayer did not make an election not to deduct the additional first year depreciation deduction for the class of property applicable to the remaining carryover basis, the taxpayer may

claim the additional first year depreciation deduction allowable for the remaining carryover basis in accordance with paragraph (f)(5) of this section either—

(A) By filing an amended return (or a qualified amended return, if applicable (for further guidance, *see* Rev. Proc. 94–69 (1994–2 C.B. 804) and § 601.601(d)(2)(ii)(*b*) of this chapter)) on or before December 31, 2003, for the year of replacement and any affected subsequent taxable year; or,

(B) By following the applicable administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, *see* Rev. Proc. 2002–9 (2002–1 C.B. 327) and § 601.601(d)(2)(ii)(*b*) of this chapter).

(iii) *Revisions made in paragraphs (b)(4) and (c)(2)(ii) of this section.* If a taxpayer did not claim on a Federal tax return for a taxable year ending on or after September 11, 2001, and on or before September 1, 2006, any additional first year depreciation deduction for qualified New York Liberty Zone property because of the application of § 1.1400L(b)–1T(b)(4) or because the taxpayer made an election under § 1.168(k)–1T(e)(1) for a class of property that included such qualified New York Liberty Zone property, the taxpayer may claim the additional first year depreciation deduction for such qualified New York Liberty Zone property under this section in accordance with the applicable administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in method of accounting. Section 481(a) applies to a request to claim the additional first year depreciation deduction for such qualified New York Liberty Zone property under this paragraph (g)(4)(iii).

(5) *Revision to paragraphs (b)(4) and (b)(6).* The addition of ''(or, in the case of multiple units of property subject to the same lease, within three months after the date the final unit is placed in service, so long as the period between the time the first unit is placed in service and the time the last unit is placed in service does not exceed 12 months)'' to § 1.168(k)–1(b)(3)(iii)(B) and § 1.168(k)–1(b)(5)(ii)(B) applies to property sold after June 4, 2004, for purposes of paragraphs (b)(4) and (b)(6) of this section.

(6) *Rehabilitation credit.* If a taxpayer did not claim on a Federal tax return for a taxable year ending on or before September 1, 2006, the rehabilitation credit provided by section 47(a) with respect to the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures and the qualified rehabilitation expenditures are qualified New York Liberty Zone property, and the taxpayer did not make the election specified in paragraph (e)(1) of this section for the class of property that includes the qualified rehabilitation expenditures, the taxpayer may claim the rehabilitation credit for the remaining rehabilitated basis (as defined in § 1.168(k)–1(f)(10)(i)(B)) of the qualified rehabilitated building that is attributable to the qualified rehabilitation expenditures (assuming all the requirements of section 47 are met) in accordance with paragraph (f)(9) of this section by filing an amended Federal tax return for the taxable year for which the rehabilitation credit is to be claimed. The amended Federal tax return must include the adjustment to the tax liability for the rehabilitation credit and any collateral adjustments to taxable income or to the tax liability (for example, the amount of depreciation allowed or allowable in that taxable year for the qualified rehabilitated building). Such adjustments must also be made on amended Federal tax returns for any affected succeeding taxable years.

[T.D. 9091, 68 FR 53004, Sept. 8, 2003; T.D. 9091, 68 FR 63734, Nov. 10, 2003. Redesignated and amended by T.D. 9283, 71 FR 51746, Aug. 31, 2006]

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[T.D. 9889, 85 FR 1953, Jan. 13, 2020; 85 FR 19082, Apr. 6, 2020]

§ 1.1400Z2(a)–1 Deferring tax on capital gains by investing in opportunity zones.

(a) *Deferring tax on capital gains*—(1) *Overview*. Under section 1400Z–2(a) of the Internal Revenue Code (Code) and the section 1400Z–2 regulations (as defined in paragraph (b)(41) of this section), an eligible taxpayer may elect to defer recognition of some or all of one or more eligible gains that otherwise would be recognized by the eligible taxpayer in the taxable year to the extent that the eligible taxpayer timely acquires a qualifying investment in a qualified opportunity fund (QOF) within the meaning of section 1400Z–2(d)(1) and § 1.1400Z2(d)–1. Paragraph (a)(2) of this section describes how a taxpayer elects to defer gain. Paragraph (b) of this section defines terms used in the section 1400Z–2 regulations. Paragraph (c) of this section provides operational rules for applying section 1400Z–2 and the section 1400Z–2 regulations, including special rules regarding the election to defer gain under section 1400Z–2(a) and this section when an eligible taxpayer that is a partnership, S corporation, trust, or decedent's estate recognizes an eligible gain in a taxable year. Paragraph (d) of this section provides the manner in which a deferral election under section 1400Z–2(a) must be made. Paragraph (e) of this section provides the treatment of section 1400Z–2 for purposes of § 1.897–6T. Paragraph (f) of this section provides rules for mixed-funds investments. Paragraph (g) of this section provides dates of applicability. See §§ 1.1502–14Z and 1.1504–3 for special rules applicable to consolidated groups that invest in QOFs.

(2) *Procedure for deferring gain*. A taxpayer defers gain, in whole or in part, by making an election on its Federal income tax return for the taxable year in which the gain would be included if not deferred. The election must be made in the manner prescribed by the Internal Revenue Service in guidance published in the Internal Revenue Bulletin or in forms and instructions (see §§ 601.601(d)(2) and 601.602 of this chapter).

(b) *Definitions*. The following definitions apply for purposes of section 1400Z–2 and the section 1400Z–2 regulations:

(1) *30-month substantial improvement period*. The term *30-month substantial improvement period* means any 30-month period, beginning after the date of acquisition of tangible property, in which additions to the basis of the tangible property in the hands of the QOF or qualified opportunity zone business (see § 1.1400Z2(d)–2(b)(4)) exceed an amount equal to the adjusted basis of such property at the beginning of the 30-month period in the hands of the QOF or qualified opportunity zone business.

(2) *70-percent tangible property standard*. The term *70-percent tangible property standard* means the requirement in section 1400Z–2(d)(3)(A)(i) that a qualified opportunity zone business must satisfy with respect to qualified opportunity zone business property (see § 1.1400Z2(d)–2) that the qualified opportunity zone business holds, whether the qualified opportunity zone business property is owned by the qualified opportunity zone business or leased by the qualified opportunity zone business from another person.

(3) *70-percent use test*. The term *70-percent use test* means the test described in § 1.1400Z2(d)–2(d)(4)(ii) that is used to determine if a QOF or qualified opportunity zone business satisfies the requirement in sections 1400Z–2(d)(2)(D)(i)(III) and 1400Z–2(d)(3)(A)(i) that substantially all of the use of tangible property was in a qualified opportunity zone.

(4) *90-percent investment standard*. The term *90-percent investment standard* means the requirement provided in section 1400Z–2(d)(1) that a QOF must hold at least 90 percent of its assets in qualified opportunity zone property, as defined in section 1400Z–2(d)(2) and § 1.1400Z2(d)–1(c)(1), determined by the average of the percentage of qualified opportunity zone property held by the QOF as measured on the last day of the first six-month period and on the last day of the taxable year of the QOF.

(5) *90-percent qualified opportunity zone property holding period*. The term *90-percent qualified opportunity zone*

property holding period means the minimum portion of a QOF's holding period in stock of a corporation or interests in a partnership, during which the corporation or partnership qualifies as a qualified opportunity zone business in order for the stock or the partnership interests to meet the substantially all requirement under section 1400Z–2(d)(2)(B)(i)(III) to be treated as qualified opportunity zone stock or the substantially all requirement under section 1400Z–2(d)(2)(C)(iii) to be treated as qualified opportunity zone partnership interests, as applicable, held by the QOF.

(6) *90-percent qualified opportunity zone business property holding period.* The term *90-percent qualified opportunity zone business property holding period* means the minimum portion of a QOF's or qualified opportunity zone business's holding period in tangible property during which the 70-percent use test with respect to the tangible property must be satisfied, in order for the tangible property to meet the requirement under section 1400Z–2(d)(2)(D)(i)(III) to be treated as qualified opportunity zone business property held by the QOF or qualified opportunity zone business.

(7) *180-day period*—(i) *In general.* Except as otherwise provided elsewhere in this section, the term *180-day period* means the 180-day period referred to in section 1400Z–2(a)(1)(A) with respect to any eligible gain meeting the requirements of paragraph (b)(11) of this section that begins on the day on which the gain would be recognized for Federal income tax purposes if the eligible taxpayer did not elect under section 1400Z–2 and the section 1400Z–2 regulations to defer recognition of that gain.

(ii) *180-day period for RIC and REIT capital gain dividends*—(A) *General rule.* Unless the shareholder of a regulated investment company (RIC) or real estate investment trust (REIT) chooses to apply paragraph (b)(7)(ii)(B) of this section, the 180-day period for a RIC or REIT capital gain dividend begins on the last day of the shareholder's taxable year in which the capital gain dividend would otherwise be recognized by the shareholder.

(B) *Elective rule.* Notwithstanding the general rule in paragraph (b)(7)(ii)(A) of this section, a shareholder of a RIC or REIT may choose to treat the 180-day period with respect to a capital gain dividend that the shareholder receives from the RIC or REIT as beginning on the date of the dividend distribution; provided, however, that the aggregate amount of the shareholder's eligible gain with respect to capital gain dividends from the RIC or REIT is limited to the aggregate amount of capital gain dividends reported for that shareholder by the RIC for that shareholder's taxable year or designated for that shareholder by the REIT for that shareholder's taxable year.

(C) *Undistributed capital gains.* If section 852(b)(3)(D) or 857(b)(3)(C) (concerning undistributed capital gains) requires the holder of shares in a RIC or REIT to include an amount in the shareholder's long-term capital gains, the rule in paragraph (b)(7)(ii)(B) of this section does not apply to that amount. The 180-day period with respect to the included undistributed capital gain begins, at the shareholder's election, on either the last day of the RIC or REIT's taxable year or the last day of the shareholder's taxable year in which the amount would otherwise be recognized as long-term capital gains by the shareholder.

(iii) *180-day period for partners, S corporation shareholders, and owners of other passthrough entities.* See paragraph (c)(8) and (9) of this section for rules relating to the determination of the 180-day period for partners, S corporation shareholders, or beneficiaries of a trust or decedent's estate in cases in which a partnership, S corporation, trust, or decedent's estate is not an eligible taxpayer with respect to an eligible gain, or does not make a deferral election with respect to an eligible gain.

(iv) *Examples.* The following examples illustrate the principles of paragraph (b)(7)(i) through (iii) of this section.

(A) *Example 1. Regular-way trades of stock.* Individual A sells stock at a gain in a regular-way trade on an exchange (that is, in a transaction in which a trade order is placed on the trade date, and settlement of the transaction, including payment and delivery of the stock, occurs a standardized number of days after the trade date). The 180-day period with respect to A's gain on the stock begins on the trade date.

(B) *Example 2. Capital gain dividends received by a REIT shareholder.* REIT and Shareholder are calendar year taxpayers. REIT distributes a dividend to Shareholder on March 1, Year 1. REIT designates the March 1 dividend as a capital gain dividend before 30 days after the close of Year 1. Shareholder's 180-day period with respect to that capital gain dividend begins on December 31, Year 1. However, Shareholder may choose to begin the 180-day period on March 1, Year 1. If so, an equity interest in a QOF received by Shareholder in exchange for an investment of an amount corresponding to that capital gain dividend may be a qualifying investment to the extent that Shareholder's aggregate elected deferrals of dividends from REIT for Year 1 do not exceed Shareholder's aggregate capital gain dividends from REIT for the taxable year.

(C) *Example 3. Multiple capital gain dividends received by a RIC shareholder.* RIC is a calendar year taxpayer. RIC distributes a dividend of $100 to Shareholder, a calendar year taxpayer, on March 1, Year 1 and distributes another dividend of $50 to Shareholder on June 1, Year 1. RIC reports both the March 1 and June 1 dividends as capital gain dividends on Shareholder's Form 1099–DIV for Year 1. Shareholder's 180-day period with respect to both capital gain dividends begins on December 31, Year 1. However, Shareholder may choose to begin the 180-day period for the $100 RIC capital gain dividend on March 1, Year 1, and may choose to begin the 180-day period for the $50 RIC capital gain dividend on June 1, Year 1. Thus, if Shareholder makes a single investment of $200 in a QOF in exchange for an eligible interest (as defined in paragraph (b)(12) of this section) on July 1, Year 1, absent any other eligible gain, Shareholder may treat $150 of the eligible interest as a qualifying investment in the QOF (that is, the amount that corresponds to the aggregate amount of the RIC capital gain dividends in Year 1) and $50 of the eligible interest as a non-qualifying investment therein.

(D) *Example 4. Additional deferral of previously deferred gains—(1) Facts.* Taxpayer A invested in a QOF and properly elected to defer realized gain. On March 15, 2025, A disposes of its entire investment in the QOF in a transaction that, under sections 1400Z–2(a)(1)(B) and (b), triggers an inclusion of gain in A's gross income. Section 1400Z–2(b) determines the date and amount of the gain included in A's income. That date is March 15, 2025, the date on which A disposed of its entire interest in the QOF. A wants to make a deferral election with respect to A's gain from the disposal of the QOF investment.

(*2*) *Analysis.* Under paragraph (b)(7)(i) of this section, the 180-day period for making another investment in a QOF begins on the day on which section 1400Z–2(b) requires the prior gain to be included. As prescribed by section 1400Z–2(b)(1)(A), that is March 15, 2025, the date of the inclusion-triggering disposition. Thus, in order to make a deferral election under section 1400Z–2, A must invest the amount of the inclusion in the original QOF or in another QOF during the 180-day period beginning on March 15, 2025, the date when A disposed of its entire investment in the QOF.

(8) *Boot.* The term *boot* means money or other property that section 354 or 355 does not permit to be received without the recognition of gain.

(9) *Consolidated group.* The term *consolidated group* has the meaning provided in § 1.1502–1(h).

(10) *Deferral election.* The term *deferral election* means an election under section 1400Z–2(a) and the section 1400Z–2 regulations made before January 1, 2027, with respect to an eligible gain.

(11) *Eligible gain*—(i) *In general.* An amount of gain is an *eligible gain,* and thus is eligible for deferral under section 1400Z–2(a) and the section 1400Z–2 regulations, if the gain—

(A) Is treated as a capital gain for Federal income tax purposes or is a qualified 1231 gain within the meaning of paragraph (b)(11)(iii)(A) of this section, determined by—

(*1*) Not taking into account any losses unless otherwise specified in the section 1400Z–2 regulations; and

(*2*) Taking into account any other provision of the Code that requires the character of potential capital gain to be recharacterized or redetermined as ordinary income, as defined in section 64, for purposes of the Code;

(B) Would be recognized for Federal income tax purposes and subject to tax under subtitle A of the Code before January 1, 2027 (subject to Federal income tax), if section 1400Z–2(a)(1) did not apply to defer recognition of the gain; and

(C) Does not arise from a sale or exchange of property with a person that, within the meaning of section 1400Z–2(e)(2), is related to—

(*1*) The eligible taxpayer that would recognize the gain in the taxable year in which the sale or exchange occurs if section 1400Z–2(a)(1) and the section 1400Z–2 regulations did not apply to defer recognition of the gain; or

(*2*) Any passthrough entity or other person recognizing and allocating the

gain to the eligible taxpayer described in paragraph (b)(11)(i)(C)(*1*) of this section.

(ii) *Portion of eligible gain not already subject to a deferral election*. In the case of an eligible taxpayer who has made an election under section 1400Z–2(a) and the section 1400Z–2 regulations regarding some but not all of an eligible gain, the portion of that eligible gain with respect to which no election under section 1400Z–2(a) and the section 1400Z–2 regulations has been made remains an eligible gain for which a deferral election may be made.

(iii) *Qualified 1231 gains*—(A) *Definition*. A section 1231 gain (as defined in section 1231(a)(3)(A)) recognized on the sale or exchange of property defined in section 1231(b) (1231(b) property) is a *qualified 1231 gain* to the extent that it exceeds any amount with respect to the 1231(b) property that is treated as ordinary income under section 1245 or section 1250.

(B) *180-day period*. For the applicable 180-day period with respect to a qualified 1231 gain, see paragraph (b)(7) of this section.

(C) *Attributes of included income when deferral ends*. For the Federal income tax treatment of the later inclusion of a qualified 1231 gain deferred under section 1400Z–2(a)(1) and the section 1400Z–2 regulations, see paragraph (c)(1) of this section.

(iv) *Gain arising from an inclusion event*—(A) *In general*. Gain that is otherwise required to be included in gross income under §1.1400Z2(b)–1(e)(1), whether from the disposition of an entire interest in a QOF or a disposition of a partial interest, may be eligible for deferral under section 1400Z–2(a)(1), provided that all of the requirements to elect to defer gain under section 1400Z–2(a)(1)(A) are met. For purposes of determining whether such gain is eligible gain under section 1400Z–2(a)(1)(A) and this paragraph (b)(11)(iv)(A), the eligible taxpayer should treat such inclusion gain as if it was originally realized upon the occurrence of the inclusion event rather than on the sale or exchange that gave rise to the eligible gain to which the inclusion event relates.

(B) *180-day period*. The 180-day period for investing gain from an inclusion event begins on the date of the inclusion event.

(C) *Holding period*. The holding period for a qualifying investment attributable to eligible gain arising from an inclusion event begins on the date that the gain is reinvested in a QOF.

(v) *No deferral for gain realized upon the acquisition of an eligible interest*. Gain is not eligible for deferral under section 1400Z–2(a)(1) and the section 1400Z–2 regulations if such gain is realized upon the contribution, exchange, or other transfer of property to a QOF in exchange for an eligible interest (see paragraph (c)(6)(ii)(C) of this section) or the transfer of property to an eligible taxpayer in exchange for an eligible interest (see paragraph (c)(6)(iv) of this section).

(vi) *Gain from section 1256 contracts and from positions in a straddle*—(A) *General rule*. Except as otherwise explicitly provided in paragraph (b)(11)(vi)(B), (C), or (D) of this section, eligible gain for a taxable year does not include—

(*1*) Gain from a section 1256 contract as defined in section 1256(b);

(*2*) Gain from a position that was part of a straddle as defined in section 1092 (straddle) during the taxable year; or

(*3*) Gain from a position that was part of a straddle in a previous taxable year if, under section 1092(a)(1)(B), a loss from any position in that straddle is treated as sustained, subject to the limitations of section 1092(a)(1)(A), during the taxable year.

(B) *Exception for net gain from certain section 1256 contracts*. Paragraph (b)(11)(vi)(A)(*1*) of this section does not apply to the net gain during the taxable year from section 1256 contracts that were not part of a straddle at any time during the taxable year (qualified section 1256 contracts). For purposes of this paragraph (b)(11)(vi)(B), the net gain during the taxable year from qualified section 1256 contracts is determined by taking into account all capital gains and losses from such contracts for the taxable year that are recognized for Federal income tax purposes, determined without regard to section 1400Z–2(a)(1). The 180-day period with respect to any eligible gain described in this paragraph (b)(11)(vi)(B)

begins on the last day of the taxable year, and the character of that gain when it is later included under sections 1400Z–2(a)(1)(B) and 1400Z–2(b) is determined under the general rule in paragraph (c)(1) of this section. If, under section 1256(a)(4), section 1092 does not apply to a straddle, such straddle is not treated as a straddle for purposes of this paragraph (b)(11)(vi)(B).

(C) *Exception for net gain from certain identified straddles*—(*1*) Paragraph (b)(11)(vi)(A) of this section does not apply to the net gain during the taxable year from positions in a straddle if—

(*i*) During the taxable year, the positions were part of an identified straddle under section 1092(a)(2), part of an identified mixed straddle under §1.1092(b)–3T (and, as applicable, §1.1092(b)–6), part of an identified straddle under section 1256(d), or included in a mixed straddle account under §1.1092(b)–4T;

(*ii*) All gains and losses with respect to the positions that were part of such straddle or included in such mixed straddle account are recognized by the end of the taxable year (other than gain that would be recognized but for deferral under section 1400Z–2(a)(1));

(*iii*) None of the positions in such straddle or mixed straddle account were part of a straddle during the taxable year, other than a straddle described in paragraph (b)(11)(vi)(C)(*1*)(*i*) and (*ii*) of this section; and

(*iv*) None of the positions in such straddle or mixed straddle account were part of a straddle in a previous taxable year if, under section 1092(a)(1)(B), a loss from any position in such straddle is treated as sustained, subject to the limitations of section 1092(a)(1)(A), during the taxable year.

(*2*) For purposes of paragraph (b)(11)(vi)(C)(*1*) of this section, net gain during the taxable year from an identified straddle or mixed straddle account described in paragraph (b)(11)(vi)(C)(*1*)(*i*) through (*iv*) of this section is equal to the excess of the capital gains recognized in the taxable year for Federal income tax purposes, determined without regard to section 1400Z–2(a)(1), from all of the positions that were part of that straddle over the sum of the capital losses and net ordinary loss (if any) from all of the positions that were part of that straddle. For purposes of this paragraph (b)(11)(vi)(C)(*2*), capital gains and losses from an identified straddle or mixed straddle account include capital gains and losses from section 1256 contracts and other positions marked to market either upon termination or on the last business day of the taxable year, as well as annual account net gain from positions in a mixed straddle account covered by §1.1092(b)–4T. In addition, for purposes of this paragraph (b)(11)(vi)(C)(*2*), *net ordinary loss* means the excess of ordinary losses over ordinary gains.

(*3*) If a straddle is an identified straddle described in section 1092(a)(2), the basis adjustment provisions described in sections 1092(a)(2)(A)(ii) and (iii) must be applied in determining the net gain during the taxable year from positions that were part of that straddle.

(*4*) The 180-day period with respect to any eligible gain described in paragraph (b)(11)(vi)(C)(*2*) of this section begins on the earlier of the date when all of the positions that are, or have been, part of the straddle are disposed of (or otherwise terminated) or the last day of the taxable year.

(*5*) If net gain described in paragraph (b)(11)(vi)(C)(*2*) of this section is deferred under section 1400Z–2(a)(1), that gain is not treated as unrecognized gain for purposes of section 1092(a)(3)(A)(ii).

(D) *Additional exceptions to the general rule.* Additional exceptions to the general rule in paragraph (b)(11)(vi)(A) of this section may be prescribed in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(E) *Examples.* The following examples illustrate the rules described in paragraph (b)(11)(vi) of this section. All of the examples assume that Taxpayer holds the positions described as capital assets and that Taxpayer holds no offsetting positions other than those described in the examples.

(*1*) *Example 1.* Taxpayer owns 100 shares of publicly traded Company X common stock and acquires put options on 100 shares of Company X common stock during the taxable year. Taxpayer does not make any straddle

identifications under section 1092. During the taxable year, Taxpayer sells all 100 shares of its Company X common stock and has a $40 capital gain. During the taxable year, Taxpayer also closes out all of its put options on Company X common stock and has a $30 capital loss. That $40 of capital gain is from a position that was part of a straddle during the taxable year because the position in Company X common stock and the position in put options on Company X stock are offsetting positions as defined in section 1092(c). Under paragraph (b)(11)(vi)(A) of this section, none of Taxpayer's $40 of capital gain is eligible gain.

(*2*) *Example 2*. Taxpayer's taxable year is the calendar year. Taxpayer owns 100 shares of publicly traded Company Y common stock and has a basis in each share of $10.00. Taxpayer also owns put options on 100 shares of Company Y common stock. Taxpayer makes a valid and timely identification under section 1092(a)(2) of the 100 shares of Company Y common stock and the put options on the 100 shares of Company Y common stock. On January 10, Year 1, Taxpayer closes out all of the put options and has a $30.00 capital loss. On March 10, Year 1, Taxpayer sells 40 shares of the Company Y common stock for $11.00 per share. At the end of Year 1, the fair market value of each of the 60 remaining shares of Company Y common stock held by Taxpayer is $10.50. Under section 1092(a)(2)(A)(ii), when the put options are closed out at a loss of $30.00, the basis of each of Taxpayer's shares of Company Y common stock is increased by $0.30 ($30.00/100). Thus, Taxpayer has a gain of $28.00 ((40 * $11.00) – (40 * $10.30)) on the sale of the 40 shares of Company Y common stock. Paragraph (b)(11)(vi)(A) of this section applies to all of Taxpayer's gain during the taxable year from the straddle. Because Taxpayer has unrecognized gain from the straddle at the end of the taxable year, paragraph (b)(11)(vi)(C) of this section does not shield any of Taxpayer's gain from that result. The $28 of gain is thus not eligible gain. Taxpayer must recognize and include in taxable income for the taxable year the $28.00 capital gain. Under section 1092(a)(2)(A)(iv), Taxpayer may not deduct the $30.00 loss from the put options.

(*3*) *Example 3*. The facts are the same as in paragraph (b)(11)(vi)(E)(*2*) of this section (*Example 2*), except Taxpayer sells the 100 shares of Company Y common stock on March 10, Year 1, for $11.50 per share. Under section 1092(a)(2)(A)(ii), as in paragraph (b)(11)(vi)(E)(*2*) of this section (*Example 2*), when the put options are closed out at a loss of $30.00, the basis of each of Taxpayer's shares of Company Y common stock is increased by $0.30 ($30.00/100). Taxpayer has a gain of $120.00 ((100 * $11.50) – (100 * $10.30)) on the sale of the 100 shares of Company Y common stock. Taxpayer has net gain during the taxable year from the identified straddle of $120.00. Under paragraph (b)(11)(vi)(C) of this section, paragraph (b)(11)(vi)(A) of this section does not apply to prevent the $120.00 net gain from being eligible gain. As in paragraph (b)(11)(vi)(E)(*2*) of this section (*Example 2*), under section 1092(a)(2)(A)(iv), Taxpayer may not deduct the $30.00 loss from the put options.

(*4*) *Example 4*. Taxpayer's taxable year is the calendar year. Taxpayer owns 100 shares of publicly traded Company Z common stock and has a basis in each share of $10. Taxpayer also owns put options on 100 shares of Company Z common stock. In Year 1, Taxpayer closes out the put options at a $100 loss. At the end of Year 1, the fair market value of each of the shares of Company Z common stock held by Taxpayer is $15 and, under section 1092(a)(3), Taxpayer has $500 of unrecognized gain. Because Taxpayer's unrecognized gain on the Company Z common stock at the end of Year 1 exceeds Taxpayer's loss on the put options, Taxpayer's loss is deferred under section 1092(a)(1). During Year 2, Taxpayer sells 40 shares of Company Z common stock for $14 per share. Taxpayer has a gain of $160 ((40 * $14) – (40 * $10)) on the sale of the 40 shares of Company Z common stock. Under paragraph (b)(11)(vi)(A) of this section, because Taxpayer's Company Z common stock was part of a straddle in a previous taxable year and a loss from a position in that straddle was deferred under section 1092(a) at the end of Year

1, the preceding taxable year, Taxpayer's $160 Year 2 gain on the sale of the Company Z common stock is not eligible gain. At the end of Year 2, the fair market value of each of the 60 remaining shares of Company Z common stock held by Taxpayer is $10 and Taxpayer has no unrecognized gain on its Company Z common stock. Under section 1092(a)(1)(B), Taxpayer's $100 loss from Year 1 is treated as sustained in Year 2. Because Taxpayer has no unrecognized gain on its Company Z common stock at the end of Year 2, Taxpayer may deduct the $100 loss in Year 2. In Year 3, Taxpayer sells the remaining 60 shares of Company Z common stock for $50 per share. Taxpayer has a gain of $2,400 ((60 * $50) − (60 * $10)) on the sale of the 60 shares of Company Z common stock. Because there was no loss from the straddle deferred under section 1092(a) at the end of Year 2, paragraph (b)(11)(vi)(A) of this section does not apply to prevent the $2,400 of Year 3 net gain from being eligible gain.

(*5*) *Example 5*. Taxpayer's taxable year is the calendar year. On October 5, Year 1, Taxpayer buys 100 shares of publicly traded Exchange Traded Fund A (ETF A) and acquires offsetting section 1256 contracts on the index that underlies the ETF A shares. Taxpayer makes a valid and timely identification of all 100 ETF A shares and the offsetting section 1256 contracts under § 1.1092(b)–3T. On December 31, Year 1, the fair market value of the ETF A shares has increased by $500, and the fair market value of the section 1256 contracts has decreased by $450. On December 31, Year 1, Taxpayer sells the ETF shares for a $500 gain. In addition, under section 1256(a)(1), the section 1256 contracts are treated as sold for fair market value on December 31, Year 1, for a $450 loss. Pursuant to § 1.1092(b)–3T(b)(4), Taxpayer has a net short term capital gain from the identified mixed straddle of $50 ($500–$450). Under paragraph (b)(11)(vi)(C) of this section, paragraph (b)(11)(vi)(A) of this section does not apply to prevent the $50 of net short term capital gain from being eligible gain.

(vii) [Reserved]

(viii) *Eligible installment sale gains*—(A) *In general*. The term *eligible gain* includes gains described in this paragraph (b)(11) that would be recognized by an eligible taxpayer under the installment method pursuant to section 453 and with §§ 1.453–1 through 1.453–12 for a taxable year, provided such gain otherwise meets the requirements of this paragraph (b)(11). This includes gains recognized under the installment method under section 453 from an installment sale that occurred before December 22, 2017.

(B) *180-day period for gain from installment sales*. For gains reported on the installment method, an eligible taxpayer may treat the date the payment on the installment sale is received or the last day of the taxable year in which the eligible taxpayer would have recognized the gain under the installment method as the beginning of the 180-day period described in paragraph (b)(7) of this section. Thus, if an eligible taxpayer receives one or more payments on an installment sale and treats the date the payment on the installment sale is received as the beginning of the 180-day period, each payment will begin a new 180-day period.

(ix) *Additional rules for determining if gain is subject to Federal income tax*—(A) *Application of a treaty*—(*1*) *In general*. For purposes of paragraph (b)(11)(i)(B) of this section, whether gain would be subject to Federal income tax is determined after application of any treaty exemption provision that an eligible taxpayer elects to apply under any applicable U.S. income tax convention.

(*2*) *Treaty waiver*. An eligible taxpayer who is not a United States person within the meaning of section 7701(a)(30) (or an eligible taxpayer who is a United States person within the meaning of section 7701(a)(30) but who is treated as a resident of another country under an applicable U.S. income tax convention) may not make an election to defer gain pursuant to section 1400Z–2(a) after the applicability date of this section (see paragraph (g) of this section) unless such eligible taxpayer irrevocably waives, in accordance with forms and instructions (see § 601.602 of this chapter), any treaty benefits that would exempt such gain from being subject to Federal income tax at the time of inclusion pursuant to an applicable U.S. income tax convention. In the event

that such forms and instructions that include such waiver have not yet been published when an election pursuant to paragraph (d)(1) of this section is required to be made, such an eligible taxpayer must attach a written statement, signed under penalties of perjury, to any forms on which an election is made pursuant to paragraph (d)(1) of this section, which states ''With respect to gain deferred pursuant to an election under section 1400Z–2(a), the below signed taxpayer irrevocably waives any treaty benefits that would exempt such gain from being subject to Federal income tax at the time of inclusion pursuant to an applicable U.S. income tax convention.'' If such an eligible taxpayer chooses to apply the section 1400Z–2 regulations in a consistent manner for all taxable years (see paragraph (g)(2)(i) of this section), the taxpayer must include the signed statement required under this paragraph (b)(11)(ix)(A)(*2*) with the first annual report described in paragraph (d)(2) of this section that is required to be filed on a date that is after March 13, 2020. An eligible taxpayer not described in the first sentence of this paragraph (b)(11)(ix)(A)(*2*) will only be required to make the waiver described in this paragraph (b)(11)(ix)(A)(*2*) if and to the extent required in forms and instructions (see § 601.602 of this chapter).

(*3*) *Non-application to certain entities.* This paragraph (b)(11)(ix)(A) does not apply to an entity described in paragraph (b)(11)(ix)(B) of this section.

(B) *Gain of a partnership.* Subject to § 1.1400Z2(f)–1(c), with respect to a partnership, the requirement in paragraph (b)(11)(i)(B) of this section that a gain be subject to Federal income tax does not apply to an otherwise eligible gain of the partnership, provided the partnership acquires the eligible interest with respect to such gain. See § 1.1400Z2(f)–1(c)(3)(i) and (ii), *Examples 1 and 2*, for illustrations of the application of § 1.1400Z2(f)–1(c) (providing an anti-abuse rule) to a partnership.

(12) *Eligible interest*—(i) *In general.* For purposes of section 1400Z–2, an *eligible interest* in a QOF is an equity interest issued by the QOF, including preferred stock or a partnership interest with special allocations. Thus, the term *eligible interest* excludes any debt instrument including those within the meaning of section 1275(a)(1) and § 1.1275–1(d). An eligible interest includes a pre-existing interest in an entity that becomes a QOF pursuant to § 1.1400Z2(d)–1(a)(1)(iii).

(ii) *Use as collateral permitted.* Provided that the eligible taxpayer is the owner of the equity interest in the QOF for Federal income tax purposes, status as an eligible interest is not impaired by using the interest as collateral for a loan, whether as part of a purchase-money borrowing or otherwise.

(iii) *Deemed contributions not creating mixed-funds investment.* See paragraph (f)(2) of this section for rules regarding deemed contributions of money to a partnership pursuant to section 752(a).

(13) *Eligible taxpayer.* An *eligible taxpayer* is a person that is required to report the recognition of gains during the taxable year under Federal income tax accounting principles. Thus, for example, eligible taxpayers include individuals; C corporations, including RICs and REITs; organizations subject to tax under section 511; and partnerships, S corporations, trusts, and decedents' estates to the extent permitted by paragraphs (c)(7) through (9) of this section.

(14) *Inclusion event.* The term *inclusion event* has the meaning provided in § 1.1400Z2(b)–1(c).

(15) *Mixed-funds investment.* The term *mixed-funds investment* means an investment a portion of which is a qualifying investment and a portion of which is a non-qualifying investment.

(16) *Non-qualifying investment.* The term *non-qualifying investment* means an investment in a QOF described in section 1400Z–2(e)(1)(A)(ii).

(17) *Property*—(i) *In general.* The term *property* means money, securities, or any other property.

(ii) *Inclusion events regarding QOF corporation distributions.* For purposes of § 1.1400Z2(b)–1(c), in the context in which a QOF corporation makes a distribution, the term *property* does not include stock (or rights to acquire stock) in the QOF corporation that makes the distribution.

(18) *QOF.* The term *QOF* means a qualified opportunity fund, as defined in section 1400Z–2(d)(1) and § 1.1400Z2(d)–1.

(19) *QOF C corporation*. The term *QOF C corporation* means a QOF corporation other than a QOF S corporation.

(20) *QOF corporation*. The term *QOF corporation* means a QOF that is classified as a corporation for Federal income tax purposes.

(21) *QOF RIC*. The term *QOF RIC* means a QOF that elects to be taxed as a RIC for Federal income tax purposes. For purposes of section 1400Z–2 and the section 1400Z–2 regulations, a *RIC* is a regulated investment company within the meaning of section 851.

(22) *QOF REIT*. The term *QOF REIT* means a QOF that elects to be taxed as a REIT for Federal income tax purposes. For purposes of section 1400Z–2 and the section 1400Z–2 regulations, a *REIT* is a real estate investment trust within the meaning of section 856.

(23) *QOF owner*. The term *QOF owner* means a QOF shareholder or a QOF partner.

(24) *QOF partner*. The term *QOF partner* means a person that directly owns a qualifying investment in a QOF partnership or a person that owns such a qualifying investment through equity interests solely in one or more partnerships.

(25) *QOF partnership*. The term *QOF partnership* means a QOF that is classified as a partnership for Federal income tax purposes.

(26) *QOF S corporation*. The term *QOF S corporation* means a QOF corporation that has elected under section 1362 to be an S corporation.

(27) *QOF shareholder*. The term *QOF shareholder* means a person that directly owns a qualifying investment in a QOF corporation.

(28) *QOZ designation notice*. The term *QOZ designation notice* means a notice designating population census tracts as qualified opportunity zones (QOZs) in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(29) *Qualified opportunity zone business*. The term *qualified opportunity zone business* has the meaning provided in section 1400Z–2(d)(3) and § 1.1400Z2(d)–1(d).

(30) *Qualified opportunity zone business property*. The term *qualified opportunity zone business property* has the meaning provided in section 1400Z–2(d)(2)(D) and § 1.1400Z2(d)–2.

(31) *Qualified opportunity zone partnership interest*. The term *qualified opportunity zone partnership interest* has the meaning provided in section 1400Z–2(d)(2)(C) and § 1.1400Z2(d)–1(c)(3).

(32) *Qualified opportunity zone property*. The term *qualified opportunity zone property* has the meaning provided in section 1400Z–2(d)(2)(A) and § 1.1400Z2(d)–1(c)(1).

(33) *Qualified opportunity zone stock*. The term *qualified opportunity zone stock* has the meaning provided in section 1400Z–2(d)(2)(B) and § 1.1400Z2(d)–1(c)(2).

(34) *Qualifying investment*. The term *qualifying investment* means an eligible interest, or portion thereof, in a QOF to the extent that a deferral election is made and applies with respect to such eligible interest or portion thereof and the IRS has been timely notified of the deferral election. An eligible interest in a QOF ceases to be a qualifying investment of the owner upon, and to the extent of, the occurrence of an inclusion event with regard to that eligible interest, or portion thereof, except as is expressly provided otherwise in § 1.1400Z2(b)–1(c) or other provisions of the section 1400Z–2 regulations.

(35) *Qualifying QOF partnership interest*. The term *qualifying QOF partnership interest* means a direct or indirect interest in a QOF partnership that is a qualifying investment.

(36) *Qualifying QOF stock*. The term *qualifying QOF stock* means stock in a QOF corporation that is a qualifying investment.

(37) *Qualifying section 355 transaction*. The term *qualifying section 355 transaction* means a distribution described in § 1.1400Z2(b)–1(c)(11)(i)(B).

(38) *Qualifying section 381 transaction*. The term *qualifying section 381 transaction* means a transaction described in section 381(a)(2), except the following transactions:

(i) An acquisition of assets of a QOF by a QOF shareholder that holds a qualifying investment in the QOF;

(ii) An acquisition of assets of a QOF by a tax-exempt entity as defined in § 1.337(d)–4(c)(2);

(iii) An acquisition of assets of a QOF by an entity operating on a cooperative

basis within the meaning of section 1381;

(iv) An acquisition by a QOF of assets of a QOF shareholder that holds a qualifying investment in the QOF;

(v) A reorganization of a QOF in a transaction that qualifies under section 368(a)(1)(G);

(vi) A transaction, immediately after which one QOF owns an investment in another QOF; and

(vii) A triangular reorganization of a QOF within the meaning of §1.358–6(b)(2)(i), (ii), or (iii).

(39) *Related persons*. The term *related* when used with regard to persons and the term *related persons* means that there is a relationship described in section 267(b) or 707(b)(1), determined by substituting ''20 percent'' for ''50 percent'' each place it occurs in such sections. The term *unrelated* when used with regard to persons means that there is no relationship described in preceding sentence.

(40) *Remaining deferred gain*. With respect to a qualifying investment, the term *remaining deferred gain* means the full amount of gain that was deferred under section 1400Z–2(a)(1)(A), reduced by the amount of gain previously included under §1.1400Z2(b)–1(b). After December 31, 2026, an eligible taxpayer's remaining deferred gain is $0.

(41) *Section 1400Z–2 regulations*. The term *section 1400Z–2 regulations* means the regulations in this chapter, which are prescribed in whole or in part under section 1400Z–2.

(c) *Operational and special rules*—(1) *Attributes of gains included in income under section 1400Z–2(a)(1)(B)*. If section 1400Z–2(a)(1)(B), section 1400Z–2(b), and the section 1400Z–2 regulations require a taxpayer to include in income some or all of a previously deferred gain, the rules of paragraphs (c)(1)(i) and (ii) of this section apply with respect to such gain.

(i) *Deferral year attributes*. The gain so included per paragraph (c)(1) of this section has the same attributes in the taxable year of inclusion that the gain would have had if recognition of the gain had not been deferred under section 1400Z–2(a)(1)(A). These attributes include those taken into account by sections 1(h), 1222, 1231(b), 1256, and any other applicable provisions of the Code.

(ii) *Inclusion year treatment*. The gain so included per paragraph (c)(1) of this section is subject to the same Federal income tax provisions and rates that would apply to any other gains that are realized and recognized at the same time as the included gain and that have the same attributes as the deferred gain. For example, when a deferred qualified 1231 gain, as defined in paragraph (b)(11)(iii) of this section, is required to be included in income, the included section 1231 gain is treated as if it were a section 1231 gain (within the meaning of section 1231(a)(3)(A)) that was recognized on the date of inclusion.

(iii) *Rules for associating included gain with deferred gains*—(A) *In general*. For purposes of paragraphs (c)(1)(i) and (ii) of this section, a taxpayer determines which previously deferred gain is associated with a qualifying investment in accordance with guidance published in the Internal Revenue Bulletin or in forms and instructions (see §§601.601(d)(2) and 601.602 of this chapter). The rules of paragraphs (c)(1)(iii)(B) and (C) of this section apply only to the extent a deferred gain is not clearly associated with a particular qualifying investment under this paragraph (c)(1)(iii)(A).

(B) *Only one eligible gain associated with a deferral election*. If only one eligible gain could have been deferred with respect to a qualifying investment, that deferred gain is associated with that qualifying investment. For example, if an eligible taxpayer makes a deferral election with respect to an investment in a QOF and only one eligible gain of the taxpayer satisfies the 180-day period with respect to the investment in the QOF, that eligible gain is the gain deferred with respect to the qualifying investment for purposes of paragraphs (c)(1)(i) and (ii) of this section.

(C) *Multiple eligible gains associated with a deferral election—(1) In general*. If more than one eligible gain may have been deferred with respect to an investment in a QOF for which a deferral election has been made, then for purposes of paragraphs (c)(1)(i) and (ii) of this section, the eligible taxpayer is treated as making the investment in

the QOF first with respect to the earliest realized eligible gain, followed by the next earliest eligible gain and any other eligible gains in order of the date of their realization.

(*2*) *Rule for gains realized on the same day*. If in the application of paragraph (c)(1)(iii)(C)(*1*) of this section, two eligible gains are realized on the same day, such gains are allocated to the investment in the QOF proportionately.

(2) *Identification of which interest in a QOF corporation has been disposed of*—(i) *Need for identification*. If a taxpayer holds shares of QOF stock with identical rights (*fungible interests*), and if the taxpayer disposes of less than all of the fungible interests, it is necessary to identify which interest or interests were disposed of. A taxpayer may effect this identification in accordance with the rules and principles of §1.1012–1(c). Consistent with §1.1012–1(c), if a taxpayer does not adequately identify which of the fungible interests are disposed of, the first-in, first-out identification method (*FIFO method*) applies.

(ii) *Consequences of identification*. The identification determines—

(A) Whether an investment disposed of is a qualifying investment or a nonqualifying investment; and

(B) In the case of qualifying investments—

(*1*) The attributes of the gain addressed in paragraph (c)(1) of this section; and

(*2*) The extent, if any, of an increase under section 1400Z–2(b)(2)(B) in the basis of an investment interest that is disposed of.

(3) *Pro-rata method*. If, after application of the FIFO method, a taxpayer is treated as having disposed of less than all of the investment interests that the taxpayer acquired on one day, and if the interests acquired on that day vary with respect to the characteristics described in paragraph (c)(2)(ii) of this section, then a proportionate allocation must be made to determine which interests were disposed of (*pro-rata method*).

(4) *Examples*. The following examples illustrate the rules of paragraph (c)(1) through (3) of this section.

(i) *Example 1. Short-term gain*. For 2018, taxpayer B properly made an election under section 1400Z–2 to defer $100 of eligible gain that, if not deferred, would have been recognized as short-term capital gain, as defined in section 1222(1). In 2022, sections 1400Z–2(a)(1)(B) and (b) require taxpayer B to include the gain in gross income. Under paragraph (c)(1) of this section, the gain included in 2022 is short-term capital gain.

(ii) *Example 2. Collectibles gain*. For 2018, taxpayer C properly made an election under section 1400Z–2 to defer a gain that, if not deferred, would have been collectibles gain as defined in section 1(h)(5). In a later taxable year, section 1400Z–2(a)(1)(B) and (b) requires some or all of that deferred gain to be included in gross income. The gain included is collectibles gain.

(iii) *Example 3. Net capital gain from section 1256 contracts*. For 2019, taxpayer D had $100 of net capital gain realized from section 1256 contracts that is eligible gain under paragraph (b)(11)(vi)(B) of this section. D timely invested $100 in a QOF and properly made an election under section 1400Z–2 to defer that $100 of gain. In 2023, section 1400Z–2(a)(1)(B) and (b) requires D to include that deferred gain in gross income. Under paragraph (c)(1) of this section, the character of the inclusion is governed by section 1256(a)(3), which requires a 40:60 split between short-term and long-term capital gain. Accordingly, $40 of the inclusion is short-term capital gain and $60 of the inclusion is long-term capital gain.

(iv) *Example 4. FIFO method*. For 2018, taxpayer E properly made an election under section 1400Z–2 to defer $300 of short-term capital gain. For 2020, E properly made a second election under section 1400Z–2 to defer $200 of long-term capital gain. In both cases, E properly invested in QOF corporation Q the amount of the gain to be deferred, resulting in a total investment in Q of $500. The two investments are fungible interests and the price of the interests was the same at the time of the two investments. E did not purchase any additional interest in Q or sell any of its interest in Q until 2024, when E sold for a gain 60 percent of its interest in Q. E did not adequately identify which investment in QOF Q E sold. Under paragraph (c)(2)(i) of this section, E must apply the FIFO method to identify

which investments in Q that E disposed of. 60 percent of E's total investment in Q is $300 (60% × $500), thus under the FIFO method, E sold its entire 2018 initial investment of $300 in Q. Under section 1400Z–2(a)(1)(B) and (b), the sale triggered an inclusion of deferred gain. Because the inclusion has the same character as the gain that had been deferred, the inclusion is short-term capital gain.

(v) *Example 5. FIFO method.* In 2018, before Corporation R became a QOF, Taxpayer F invested $100 to R in exchange for 100 R common shares. Later in 2018, after R was a QOF, F invested $500 to R in exchange for 400 R common shares and properly elected under section 1400Z–2 to defer $500 of realized short-term capital gain from a separate investment. Even later in 2018, on different days, F realized $300 of short-term capital gain and $700 of long-term capital gain. On a single day that fell during the 180-day period for both of those gains, F invested $1,000 in R in exchange for 800 R common shares and properly elected under section 1400Z–2 to defer the two gains. In 2020, F sold 100 R common shares. F did not adequately identify which investment in R F sold. Under paragraph (c)(2)(i) of this section, F must apply the FIFO method to identify which investments in R F disposed of. As determined by that identification, F sold the initially acquired 100 R common shares, which were not part of a deferral election under section 1400Z–2. R must recognize gain or loss on the sale of its R shares under the generally applicable Federal income tax rules, but the sale does not trigger an inclusion of any deferred gain.

(vi) *Example 6. FIFO method.* The facts are the same as in paragraph (c)(4)(v) of this section (*Example 5*), except that, in addition, during 2021 F sold an additional 400 R common shares, and, as with the other sale, F did not adequately identify which investment in QOF R F sold. Under paragraph (c)(2)(i) of this section, F must apply the FIFO method to identify which investments in R were disposed of. As determined by this identification, F sold the 400 common shares which were associated with the deferral of $500 of short-term capital gain. Thus, the deferred gain that must be included upon sale of the 400 R common shares is short-term capital gain.

(vii) *Example 7. Pro-rata method.* The facts are the same as in examples 5 and 6, except that, in addition, during 2022 F sold an additional 400 R common shares. Under paragraph (c)(2)(i) of this section, F must apply the FIFO method to identify which investments in R were disposed of. In 2022, F is treated as holding only the 800 R common shares purchased on a single day, and the section 1400Z–2 deferral election associated with these shares applies to gain with different characteristics (described in paragraph (c)(2)(ii) of this section). Under paragraph (c)(3) of this section, therefore, R must use the pro-rata method to determine which of the characteristics pertain to the deferred gain required to be included as a result of the sale of the 400 R common shares. Under the pro-rata method, $150 of the inclusion is short-term capital gain ($300 × 400/800) and $350 is long-term capital gain ($700 × 400/800).

(5) *Making an investment for purposes of an election under section 1400Z–2(a)*—(i) *Transfer of cash or other property to a QOF.* A taxpayer makes an investment in a QOF by transferring cash or other property to a QOF in exchange for eligible interests in the QOF, regardless of whether the transfer is one in which the transferor would recognize gain or loss on the property transferred.

(ii) *Furnishing services.* Rendering services to a QOF is not a transfer of cash or other property to a QOF. Thus, if a taxpayer receives an eligible interest in a QOF for services rendered to the QOF or to a person in which the QOF holds any direct or indirect equity interest, then the interest in the QOF that the taxpayer receives is a nonqualifying investment.

(iii) *Acquisition of eligible interest from person other than QOF.* An eligible taxpayer may make an investment in a QOF by acquiring an eligible interest in a QOF from a person other than the QOF, provided that all of the requirements of section 1400Z–2(a)(1) and the section 1400Z–2 regulations for making a valid deferral election with respect to that investment are otherwise satisfied with respect to such acquisition. For

example, an eligible taxpayer who acquires an eligible interest in a QOF other than from the QOF also must have an eligible gain within the 180-day period prior to the eligible taxpayer's acquisition of the eligible interest in the QOF.

(6) *Amount invested for purposes of section 1400Z–2(a)(1)(A)*—(i) *In general.* In the case of any investments described in this paragraph (c)(6), the amount of a taxpayer's qualifying investment cannot exceed the amount of eligible gain to be deferred under the deferral election. If the amount of an otherwise qualifying investment exceeds the amount of eligible gain to be deferred under the deferral election, the amount of the excess is treated as a non-qualifying investment. See paragraph (c)(6)(iii) of this section for special rules applicable to transfers to QOF partnerships.

(ii) *Transfers to a QOF*—(A) *Cash.* If a taxpayer makes an investment in a QOF by transferring cash to a QOF, the amount of the taxpayer's investment is that amount of cash.

(B) *Property other than cash—Nonrecognition transactions.* This paragraph (c)(6)(ii)(B) applies if a taxpayer makes an investment in a QOF by transferring property other than cash to a QOF and if, but for the application of section 1400Z–2(b)(2)(B) and the section 1400Z–2 regulations, the taxpayer's basis in the resulting investment in the QOF would be determined, in whole or in part, by reference to the taxpayer's basis in the transferred property. This paragraph (c)(6)(ii)(B) applies separately to each item of property transferred to a QOF.

(*1*) *Amount of qualifying investment.* If paragraph (c)(6)(ii)(B) of this section applies, the amount of the taxpayer's qualifying investment is the lesser of the taxpayer's adjusted basis in the eligible interest received in the transaction, without regard to section 1400Z–2(b)(2)(B) and the section 1400Z–2 regulations, or the fair market value of the eligible interest received in the transaction, both determined immediately after the transfer.

(*2*) *Fair market value of the eligible interest received exceeds its adjusted basis.* If paragraph (c)(6)(ii)(B) of this section applies, and if the fair market value of the eligible interest received is in excess of the eligible taxpayer's adjusted basis in the eligible interest received, without regard to section 1400Z–2(b)(2)(B) and the section 1400Z–2 regulations, then the eligible taxpayer's investment in a QOF is a mixed-funds investment to which section 1400Z–2(e)(1) applies. In such a case, an amount equal to the adjusted basis of the eligible interest in the hands of the eligible taxpayer is the eligible taxpayer's qualifying investment, and the excess is the eligible taxpayer's non-qualifying investment.

(*3*) *Transfer of built-in loss property and section 362(e)(2).* If paragraph (c)(6)(ii)(B) of this section and section 362(e)(2) both apply to a transaction, the eligible taxpayer and the QOF are deemed to have made an election under section 362(e)(2)(C).

(C) *Property other than cash—Taxable transactions.* This paragraph (c)(6)(ii)(C) applies if an eligible taxpayer makes an investment in a QOF by transferring property other than cash to a QOF and if, without regard to section 1400Z–2(b)(2)(B) and the section 1400Z–2 regulations, the eligible taxpayer's basis in the eligible interest received would not be determined, in whole or in part, by reference to the eligible taxpayer's basis in the transferred property. If this paragraph (c)(6)(ii)(C) applies, the amount of the eligible taxpayer's investment in a QOF is the fair market value of the transferred property, as determined immediately before the transfer. This paragraph (c)(6)(ii)(C) applies separately to each item of property transferred to a QOF.

(D) *Basis in a mixed-funds investment.* If a taxpayer's investment in a QOF is a mixed-funds investment to which section 1400Z–2(e)(1) applies, the taxpayer's basis in the non-qualifying investment is equal to the taxpayer's basis in all of the eligible interests received, determined without regard to section 1400Z–2(b)(2)(B) and the section 1400Z–2 regulations, and reduced by the basis of the taxpayer's qualifying investment, determined without regard to section 1400Z–2(b)(2)(B) and the section 1400Z–2 regulations.

(iii) *Special rules for transfers to QOF partnerships.* In the case of an investment in a QOF partnership, the following rules apply:

(A) *Amounts not treated as a qualifying investment—(1) Non-contributions in general.* To the extent the transfer of property to a QOF partnership is characterized other than as a contribution, such as characterization as a sale under section 707 and the regulations in this part under section 707 of the Code, the transfer is not treated as being made in exchange for a qualifying investment.

(*2*) *Reductions in investments otherwise treated as contributions.* If any transfer of cash or other property to a partnership is not treated as a contribution, in whole or in part, under paragraph (c)(6)(iii)(A)(*1*) of this section, the part of the transfer to the partnership that is not disregarded is not a qualifying investment to the extent the partnership makes a distribution to the partner and the transfer to the partnership and the distribution would be recharacterized as a disguised sale under section 707 and the regulations in this part under section 707 of the Code if:

(*i*) Any cash contributed were noncash property; and

(*ii*) In the case of a distribution by the partnership to which § 1.707–5(b) (relating to debt-financed distributions) applies, the partner's share of liabilities is zero.

(B) *Amount invested in a QOF partnership—(1) Calculation of amount of qualifying and non-qualifying investments.* To the extent paragraph (c)(6)(iii)(A) of this section does not apply, the amount of equity received by an eligible taxpayer in a QOF partnership in exchange for the lesser of the net basis or net value of the property contributed to the QOF partnership by the eligible taxpayer is a qualifying investment. The amount of equity received by an eligible taxpayer in a QOF partnership that is a non-qualifying investment is the excess, if any, of the total equity received by the eligible taxpayer over the amount treated as a qualifying investment.

(*2*) *Net basis.* For purposes of paragraph (c)(6)(iii)(B) of this section, net basis is the excess, if any, of—

(*i*) The adjusted basis of the property contributed to the partnership; over

(*ii*) The amount of any debt to which the property is subject or that is assumed by the partnership in the transaction.

(*3*) *Net value.* For purposes of paragraph (c)(6)(iii)(B) of this section, net value is the excess of—

(*i*) The gross fair market value of the property contributed to the partnership; over

(*ii*) The amount of the debt described in paragraph (c)(6)(iii)(B)(*2*)(*ii*) of this section.

(*4*) *Basis of qualifying and non-qualifying investments.* The initial basis of a qualifying investment, before application of section 1400Z–2(b)(2)(B) and the section 1400Z–2 regulations or any section 752 debt allocation, is the net basis of the property contributed. The basis of a non-qualifying investment, before any section 752 debt allocation, is the remaining net basis. The basis of the qualifying investment is adjusted as provided in section 1400Z–2(b)(2)(B) and the section 1400Z–2 regulations. The bases of qualifying and non-qualifying investments are increased by any debt allocated to those investments under the rules of § 1.1400Z2(b)–1(c)(6)(iv)(B).

(*5*) *Rules applicable to mixed-funds investments.* If one portion of an investment in a QOF partnership is a qualifying investment and another portion is a non-qualifying investment, see § 1.1400Z2(b)–1(c)(6)(iv) for the rules that apply.

(iv) *Acquisitions from another person.* An eligible taxpayer may make an investment in a QOF by acquiring in a sale or exchange to which § 1.1001–1(a) applies an eligible interest in a QOF from a person other than the QOF. The amount of the eligible taxpayer's investment in the QOF with respect to which the eligible taxpayer may make a deferral election is the amount of the cash, or the net fair market value of the other property, as determined immediately before the exchange, that the eligible taxpayer exchanged for the eligible interest in the QOF.

(v) *Examples.* The following examples illustrate the rules of this paragraph (c)(6).

(A) *Example 1. Transfer of built-in gain property with basis less than gain to be deferred—(1) Facts.* Individual B realizes $100 of eligible gain within the meaning of paragraph (b)(11) of this section. B transfers unencumbered property with

a fair market value of $100 and an adjusted basis of $60 to QOF Q, a C corporation, in a transaction that is described in section 351(a).

(*2*) *Analysis*. Paragraph (c)(6)(ii)(B) of this section applies because B transferred property other than cash to Q and, but for the application of section 1400Z–2(b)(2)(B), B's basis in the eligible interests in Q would be determined, in whole or in part, by reference to B's basis in the transferred property. The fair market value of the eligible interest B received is $100, and, without regard to section 1400Z–2(b)(2)(B), B's basis in the eligible interest received would be $60. Thus, pursuant to paragraph (c)(6)(ii)(B)(*2*) of this section, B's investment is a mixed-funds investment to which section 1400Z–2(e)(1) applies. Pursuant to paragraphs (c)(6)(ii)(B)(*1*) and (*2*) of this section, B's qualifying investment is $60 (the lesser of the taxpayer's adjusted basis in the eligible interest, without regard to section 1400Z–2(b)(2)(B), of $60 and the $100 fair market value of the eligible interest received). Pursuant to section 1400Z–2(b)(2)(B)(i), B's basis in the qualifying investment is $0. Additionally, B's non-qualifying investment is $40 (the excess of the fair market value of the eligible interest received ($100) over the taxpayer's adjusted basis in the eligible interest, without regard to section 1400Z–2(b)(2)(B) ($60)). B's basis in the non-qualifying investment is $0 (B's $60 basis in its investment determined without regard to section 1400Z–2(b)(2)(B), reduced by the $60 of adjusted basis allocated to the investment to which section 1400Z–2(e)(1)(A)(i) applies, determined without regard to section 1400Z–2(b)(2)(B)). See paragraph (c)(6)(ii)(D) of this section. Pursuant to section 362, Q's basis in the transferred property is $60.

(B) *Example 2. Transfer of built-in gain property with basis in excess of eligible gain to be deferred*. The facts are the same as in paragraph (c)(6)(v)(A)(*1*) of this section (*Example 1*), except that B realizes $50 of eligible gain within the meaning of paragraph (b)(11) of this section. Pursuant to paragraph (c)(6)(i) of this section, B's qualifying investment cannot exceed the amount of eligible gain to be deferred (that is, the $50 of eligible gain) under the section 1400Z–2(a) election. Therefore, pursuant to paragraph (c)(6)(ii)(B)(*1*) of this section, B's qualifying investment is $50 (the lesser of the taxpayer's adjusted basis in the eligible interest received, without regard to section 1400Z–2(b)(2)(B), of $60 and the $100 fair market value of the eligible interest, limited by the amount of eligible gain to be deferred under the section 1400Z–2(a) election). B's qualifying investment has an adjusted basis of $0, as provided in section 1400Z–2(b)(2)(B)(i). Additionally, B's non-qualifying investment is $50 (the excess of the fair market value of the eligible interest received ($100) over the amount ($50) of B's section 1400Z–2(a)(1)(A) investment). B's basis in the non-qualifying investment is $10 (B's $60 basis in its investment determined without regard to section 1400Z–2(b)(2)(B)), reduced by the $50 of adjusted basis allocated to B's qualifying investment, determined without regard to section 1400Z–2(b)(2)(B).

(C) *Example 3. Transfers to QOF partnerships*—(*1*) *Facts*. A and B each realized $100 of eligible gain and each transfers $100 to a QOF partnership. In a subsequent year, the partnership borrows $120 from an unrelated lender and distributes $120 equally to A and B.

(*2*) *Analysis*. If the contributions had been of property other than cash, the contributions and distributions would have been tested under the disguised sale rules of section 707 and the regulations in this part under section 707 of the Code, determining the timing of the distribution and amount of the debt allocated to each partner. Under paragraph (c)(6)(iii)(A)(*2*) of this section, the cash of $200 ($100 from A and $100 from B) is treated as property that could be sold in a disguised sale transaction and each partner's share of the debt is zero for purposes of determining the amount of the qualifying investment. To the extent there would have been a disguised sale applying the rule of paragraph (c)(6)(iii)(A)(*2*) of this section, the amount of the qualifying investment would be reduced by the amount of the contribution so recharacterized.

(D) *Example 4. Return of capital by QOF partnership*—(*1*) *Facts*. A realized $100 of eligible gain and transfers $100 of cash to a QOF partnership. Later in

the partner's tax year, the partnership distributes $20 to A in a distribution that is not recharacterized under paragraph (c)(6)(iii)(A)(*2*) of this section. At the time of the distribution, no allocations of income, gain, loss, or deduction had been made to A, and A's share of the partnership's debt was zero under section 752.

(*2*) *Analysis*. Because the contribution and distribution are not recharacterized under paragraph (c)(6)(iii)(A)(*2*) of this section, the amount of A's qualifying investment is $100 despite the $20 distribution. At the time the $20 distribution is made to A, A's basis in its qualifying investment is zero, and thus the distribution is an inclusion event under § 1.1400Z2(b)–1(c)(6)(iii).

(E) *Example 5. Property contributed has built-in gain*. The facts are the same as in paragraph (c)(6)(v)(C)(*1*) of this section (*Example 3*), except that the property contributed by A had a value of $100 and basis of $20 and the partnership did not borrow money or make a distribution. Under paragraph (c)(6)(iii)(B)(*1*) of this section, the amount of A's qualifying investment is $20 (the lesser of the net value or the net basis of the property that A contributed), and the excess of the $100 contribution over the $20 qualifying investment is a non-qualifying investment. Under paragraph (c)(6)(iii)(B)(*4*) of this section, A's basis in the qualifying investment (determined without regard to section 1400Z–2(b)(2)(B) or section 752(a)) is $20. After the application of section 1400Z–2(b)(2)(B) but before the application of section 752(a), A's basis in the qualifying investment is zero. A's basis in the non-qualifying investment is zero without regard to the application of section 752(a).

(*F*) *Example 6. Property contributed has built-in gain and is subject to debt*. The facts are the same as in paragraph (c)(6)(v)(E) of this section (*Example 5*), except that the property contributed by A has a gross value of $130 and is subject to debt of $30. Under paragraph (c)(6)(iii)(B)(*1*) of this section, the amount of A's qualifying investment is zero, the lesser of the property's $100 net value ($130 minus $30) or $0 net basis ($20 minus $30, but limited to zero). The entire contribution constitutes a non-qualifying investment.

(G) *Example 7. Property contributed has built-in loss and is subject to debt*. The facts are the same as in paragraph (c)(6)(v)(F) of this section (*Example 6*), except that the property contributed by A has a basis of $150. Under paragraph (c)(6)(iii)(B)(*1*) of this section, the amount of A's qualifying investment is $100, the lesser of the property's $100 net value ($130 minus $30) or $120 net basis ($150 minus $30). The non-qualifying investment is $0, the excess of the net value ($100) over the qualifying investment ($100). A's basis in the qualifying investment (determined without regard to section 1400Z–2(b)(2)(B) and section 752(a)) is $120, the net basis. After the application of section 1400Z–2(b)(2)(B), A's basis in the qualifying investment is zero, plus its share of partnership debt under section 752(a).

(7) *Eligible gains that a partnership elects to defer*. A partnership generally is an eligible taxpayer under paragraph (b)(13) of this section and may elect to defer recognition of some or all of its eligible gains under section 1400Z–2(a)(2) and the section 1400Z–2 regulations.

(i) *Partnership deferral election*. If a partnership properly makes a deferral election, then—

(A) The partnership defers recognition of the eligible gain under the rules of section 1400Z–2 and the section 1400Z–2 regulations, that is, the partnership does not recognize gain at the time it otherwise would have in the absence of the deferral election; and

(B) The deferred eligible gain is not included in the distributive shares of the partners under section 702 and is not treated as an item described in section 705(a)(1).

(ii) *Subsequent recognition*. Absent any additional deferral under section 1400Z–2(a)(1)(A) and the section 1400Z–2 regulations, any amount of deferred gain that an electing partnership subsequently must include in income under sections 1400Z–2(a)(1)(B) and (b) and the section 1400Z–2 regulations is recognized by the electing partnership at the time of inclusion, is subject to section 702 and is treated as an item described in section 705(a)(1) in a manner consistent with recognition at that time.

(8) *Eligible gains that the partnership does not defer*—(i) *Federal income tax treatment of the partnership.* If a partnership does not elect to defer some, or all, of its eligible gains, the partnership's treatment of any such amounts is unaffected by the fact that the eligible gains could have been deferred under section 1400Z–2 and the section 1400Z–2 regulations.

(ii) *Federal income tax treatment by the partners.* If a partnership does not elect to defer some, or all, of the eligible gains—

(A) The gains for which a deferral election are not made are included in the partners' distributive shares under section 702 and are treated as items described in section 705(a)(1);

(B) If a partner's distributive share includes one or more gains that are eligible gains with respect to the partner, the partner may elect under section 1400Z–2(a)(1)(A) and the section 1400Z–2 regulations to defer some or all of such eligible gains; and

(C) A gain in a partner's distributive share is an eligible gain with respect to the partner only if it is an eligible gain with respect to the partnership and it did not arise from a sale or exchange with a person that, within the meaning of section 1400Z–2(e)(2) and the section 1400Z–2 regulations, is related to the partner.

(iii) *180-day period for a partner electing deferral*—(A) *General rule.* If a partner's distributive share includes a gain that is described in paragraph (c)(8)(ii)(C) of this section (gains that are eligible gains with respect to the partner), the 180-day period with respect to the partner's eligible gains in the partner's distributive share generally begins on the last day of the partnership taxable year in which the partner's distributive share of the partnership's eligible gain is taken into account under section 706(a).

(B) *Elective rule.* Notwithstanding the general rule in paragraph (c)(8)(iii)(A) of this section, if a partnership does not elect to defer all of its eligible gain, the partner may elect to treat the partner's own 180-day period with respect to the partner's distributive share of that gain as being—

(*1*) The same as the partnership's 180-day period; or

(*2*) The 180-day period beginning on the due date for the partnership's tax return, without extensions, for the taxable year in which the partnership realized the gain that is described in paragraph (c)(8)(ii)(C) of this section.

(C) *Example.* The following example illustrates the principles of this paragraph (c)(8)(iii).

(*1*) *Facts.* Four individuals, A, B, C, and D, have equal interests in a partnership, P. P has no other partners, and P's taxable year is the calendar year. On January 17, 2019, P realizes a capital gain of $1000*x* that P decides not to elect to defer.

(*2*) *Analysis of A's election.* A is aware of the capital gain realized by P, and decides to defer its distributive shares of P's eligible gain. A invests $250*x* in a QOF during February 2020. Under the general rule in paragraph (c)(8)(iii)(A) of this section, this investment is within the 180-day period for A, which began on December 31, 2019, the last day of P's taxable year in which A's share of P's eligible gain is taken into account under section 706(a).

(*3*) *Analysis of B's election.* B is also aware of the capital gain realized by P, and decides to defer its distributive shares of P's eligible gain. B decides to make the election provided in paragraph (c)(8)(iii)(B)(*1*) of this section, and invests $250*x* in a QOF during February 2019. Under the elective rule in paragraph (c)(8)(iii)(B)(*1*) of this section, this investment is within the 180-day period for B, which began on January 17, 2019, the same day as P's 180-day period.

(*4*) *Analysis of C's election.* On March 15, 2020, P provides all of its partners with their Schedules K–1. Upon learning that its distributive share of income from P included eligible gain, C decides to make a deferral election, and also makes the election provided in paragraph (c)(8)(iii)(B)(*2*) of this section. It then invests $250*x* in a QOF during June 2020. Under the elective rule in paragraph (c)(8)(iii)(B)(*2*) of this section, this investment is within the 180-day period for C, which began on March 15, 2020, the 180-day period beginning on the due date for P's tax return without extensions, for the taxable year in which P realized eligible gain.

(9) *Passthrough entities other than partnerships*—(i) *S corporations, nongrantor trusts, and estates.* If an S corporation, a nongrantor trust, or a decedent's estate realizes an eligible gain, then rules analogous to the rules of paragraphs (c)(7) and (8) of this section apply to that entity and to its shareholders or its beneficiaries, as the case may be, to the extent they receive or are deemed to receive an allocable share of the eligible gain.

(ii) *Grantor trusts.* If a grantor trust realizes an eligible gain, either the trust or the deemed owner of the trust may make the election to defer recognition of the gain and make the qualifying investment under rules analogous to the rules of paragraphs (c)(7) and (8) of this section (other than the rule in paragraph (c)(8)(iii) of this section regarding the 180-day period), whether or not the gain is distributed to the deemed owner of the trust.

(d) *Elections*—(1) *Taxable year of deferral election.* For a deferral election with respect to any eligible gain to be valid, an eligible taxpayer must make such election in accordance with guidance published in the Internal Revenue Bulletin or in forms and instructions (see §§ 601.601(d)(2) and 601.602 of this chapter), as to the required time, form, and manner in which an eligible taxpayer (including a partner, S corporation shareholder, or beneficiary applying the elective 180-day period provided in paragraphs (c)(8)(iii)(B) and (c)(9) of this section) may make a deferral election.

(2) *Annual reporting of qualifying investments.* An eligible taxpayer must report any qualifying investment held at any point during the taxable year in accordance with guidance published in the Internal Revenue Bulletin or in forms and instructions (see §§ 601.601(d)(2) and 601.602 of this chapter). A failure to make this report for any given taxable year will result in a rebuttable presumption that the taxpayer has had an inclusion event described in § 1.1400Z2(b)–1(c) during that year. The presumption described in the previous sentence may be rebutted by the taxpayer making the report described in the first sentence of this paragraph (d)(2) or by the taxpayer establishing to the satisfaction of the Commissioner that an inclusion event described in § 1.1400Z2(b)–1(c) did not occur during that taxable year.

(e) *Interaction of section 1400Z–2 and § 1.897–6T.* Section 1400Z–2 is not a nonrecognition provision, as defined in § 1.897–6T(a)(2), for purposes of § 1.897–6T.

(f) *Treatment of mixed-funds investments*—(1) *Investments to which no election under section 1400Z–2(a) applies.* If a taxpayer invests in a QOF and makes a deferral election with respect to less than all of that investment, the portion of the investment to which the election does not apply is a non-qualifying investment. Similarly, an investment in a QOF with respect to which no deferral election is made is a non-qualifying investment.

(2) *Treatment of deemed contributions of money under section 752(a).* In the case of a QOF partnership, the deemed contribution of money described in section 752(a) does not create or increase an investment in the QOF described in section 1400Z–2(e)(1)(A)(ii). Thus, any basis increase resulting from a deemed section 752(a) contribution is not taken into account in determining the portion of a partner's investment subject to section 1400Z–2(e)(1)(A)(i) or (ii). See § 1.1400Z2(b)–1(c)(6)(iv)(B) for rules relating to the application of section 752 to a mixed-funds investment.

(3) *Treatment of contributions to QOF corporation in which no stock is received.* If a taxpayer with a qualifying investment or a non-qualifying investment in a QOF corporation subsequently makes a non-qualifying investment or a qualifying investment, respectively, and if the taxpayer receives no additional QOF stock in exchange for the subsequent investment, the taxpayer has a mixed-funds investment.

(4) *Example.* The following example illustrates the rules of this paragraph (f):

(i) *Facts.* Taxpayer A realizes $1 million of eligible gain and on the next day contributes $1 million to a QOF, Partnership P, in exchange for a 50 percent interest in Partnership P. Taxpayer A makes an election under section 1400Z–2(a) with respect to $900,000 of that eligible gain. Under section 1400Z–2(e)(1), 90 percent of A's investment is described in section 1400Z–

2(e)(1)(A)(i) (an investment that only includes amounts to which the election under section 1400Z–2(a) applies), and 10 percent is described in section 1400Z–2(e)(1)(A)(ii) (a separate investment consisting of other amounts). Partnership P borrows $8 million. Under § 1.752–3(a), taking into account the terms of the partnership agreement, $4 million of the $8 million liability is allocated to A.

(ii) *Analysis*. Under section 752(a), A is treated as contributing $4 million to Partnership P. Under paragraph (f) of this section, A's deemed $4 million contribution to Partnership P is ignored for purposes of determining the percentage of A's investment in Partnership P subject to the deferral election under section 1400Z–2(a) or the portion not subject to the deferral election under section 1400Z–2(a). As a result, after A's section 752(a) deemed contribution, $900,000, or 90 percent, of A's investment in Partnership P is described in section 1400Z–2(e)(1)(A)(i) and $100,000, or 10 percent, is described in section 1400Z–2(e)(1)(A)(ii).

(g) *Applicability dates*–(1) *In general*. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2) *Prior periods*. With respect to eligible gains that would be recognized (absent the making of a deferral election) during the portion of a taxpayer's first taxable year ending after December 21, 2017, and during taxable years beginning after December 21, 2017, and on or before March 13, 2020, a taxpayer may choose either—

(i) To apply the section 1400Z–2 regulations, if applied in a consistent manner for all such taxable years (reliance by a taxpayer under paragraph (g)(2)(ii) of this section, § 1.1400Z2(b)–1(j)(2)(ii), § 1.1400Z2(d)–1(e)(2)(ii), § 1.1400Z2(d)–2(e)(2)(ii), or § 1.1400Z2(f)–1(d)(2)(ii), is disregarded solely for purposes of the consistency requirement under this paragraph (g)(2)(i)); or

(ii) To rely on the rules in proposed § 1.1400Z2(a)–1 contained in the notice of proposed rulemaking (REG–115420–18) published on October 29, 2018, as amplified by the notice of proposed rulemaking (REG–120186–18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

[T.D. 9889, 85 FR 1954, Jan. 13, 2020; 85 FR 19083, Apr. 6, 2020]

§ 1.1400Z2(b)–1 Inclusion of gains that have been deferred under section 1400Z–2(a).

(a) *Scope*. This section provides rules under section 1400Z–2(b) of the Internal Revenue Code and the section 1400Z–2 regulations (as defined in § 1.1400Z2(a)–1(b)(41)) regarding the inclusion in income of gain deferred by a QOF owner under section 1400Z–2(a)(1)(A) and the section 1400Z–2 regulations. This section applies to a QOF owner only until all of such owner's gain deferred pursuant to a deferral election has been included in income, subject to the limitations described in paragraph (e)(5) of this section, and except as otherwise provided in paragraph (c) or (d) of this section. Paragraph (b) of this section provides general rules under section 1400Z–2(b)(1) regarding the timing of the inclusion in income of the deferred gain. Paragraph (c)(1) of this section provides the general rule regarding the determination of the extent to which an event triggers the inclusion in gross income of all, or a portion, of an eligible taxpayer's deferred gain, and paragraphs (c)(2) through (16) of this section provide specific rules for certain events that are or are not treated as inclusion events. Paragraph (d) of this section provides rules regarding holding periods for qualifying investments. Paragraph (e) of this section provides rules regarding the amount of deferred gain included in gross income under section 1400Z–2(a)(1)(B) and (b), including special rules for QOF partnerships and QOF S corporations. Paragraph (f) of this section provides examples illustrating the rules of paragraphs (c), (d), and (e) of this section. Paragraph (g) of this section provides rules regarding basis adjustments under section 1400Z–2(b)(2)(B). Paragraph (h) of this section provides special reporting rules applicable to partners, partnerships, and direct or indirect owners of QOF partnerships. Paragraph (i) is reserved. Paragraph (j) of this section provides dates of applicability.

(b) *General inclusion rule*. The gain to which a deferral election applies is included in gross income, to the extent provided in paragraph (e) of this section and in accordance with the rules of § 1.1400Z2(a)–1(c)(1), in the taxable year that includes the earlier of:

(1) The date of an inclusion event; or

(2) December 31, 2026.

(c) *Inclusion events*—(1) *In general*. Except as otherwise provided in this paragraph (c), an event is an inclusion event, if, and to the extent that—

(i) The event reduces an eligible taxpayer's direct equity interest for Federal income tax purposes in the qualifying investment;

(ii) An eligible taxpayer receives property in the event with respect to its qualifying investment and the event is treated as a distribution for Federal income tax purposes, whether or not the receipt reduces the eligible taxpayer's ownership of the QOF;

(iii) An eligible taxpayer claims a loss for worthless stock under section 165(g) or otherwise claims a worthlessness deduction with respect to its qualifying investment; or

(iv) A QOF in which an eligible taxpayer holds a qualifying investment loses its status as a QOF.

(2) *Termination or liquidation of QOF or QOF owner*—(i) *Termination or liquidation of QOF*. Except as otherwise provided in this paragraph (c), an eligible taxpayer has an inclusion event with respect to all of its qualifying investment if the QOF ceases to exist for Federal income tax purposes. For example, if a QOF partnership converts to a QOF C corporation, or if a QOF C corporation converts to a QOF partnership or to an entity disregarded as separate from its owner for Federal income tax purposes, all investors in the QOF have an inclusion event with respect to all of their qualifying investments in the QOF.

(ii) *Liquidation of QOF owner*—(A) *Portion of distribution treated as sale*. A distribution of a qualifying investment in a complete liquidation of a QOF owner is an inclusion event to the extent that section 336(a) treats the distribution as if the qualifying investment were sold to the distributee at its fair market value, without regard to section 336(d).

(B) *Distribution to 80-percent distributee*. A distribution of a qualifying investment in a complete liquidation of a QOF owner is not an inclusion event to the extent section 337(a) applies to the distribution.

(3) *Transfer of an investment in a QOF by gift or incident to divorce*—(i) *Transfer of an investment in a QOF by gift*. Except to the extent provided in paragraph (c)(5) of this section, a taxpayer's transfer of a qualifying investment by gift, as defined for purposes of chapter 12 of subtitle B of the Code, whether outright or in trust, is an inclusion event, regardless of whether that transfer is a completed gift for Federal gift tax purposes, and regardless of the taxable or tax-exempt status of the donee of the gift.

(ii) *Transfers between spouses incident to divorce*. A transfer between spouses or incident to divorce or otherwise as provided in section 1041 of the Code is an inclusion event.

(4) *Transfer of an investment in a QOF by reason of the taxpayer's death*—(i) *In general*. Except as provided in paragraph (c)(4)(ii) of this section, a transfer of a qualifying investment by reason of the taxpayer's death is not an inclusion event. Transfers by reason of death include, for example:

(A) A transfer by reason of death to the deceased owner's estate;

(B) A distribution of a qualifying investment by the deceased owner's estate;

(C) A distribution of a qualifying investment by the deceased owner's trust that is made by reason of the deceased owner's death;

(D) The passing of a jointly owned qualifying investment to the surviving co-owner by operation of law; and

(E) Any other transfer of a qualifying investment at death by operation of law.

(ii) *Exceptions*. The following transfers are not included as a transfer by reason of the taxpayer's death, and thus are inclusion events:

(A) A sale, exchange, or other disposition by the deceased taxpayer's estate or trust, other than a distribution described in paragraph (c)(4)(i) of this section;

(B) Any disposition by the legatee, heir, or beneficiary who received the

qualifying investment by reason of the taxpayer's death; and

(C) Any disposition by the surviving joint owner or other recipient who received the qualifying investment by operation of law on the taxpayer's death.

(iii) *Liability for deferred Federal income tax.* If the owner of a qualifying investment in a QOF dies before an inclusion event and the deferred gain is not includable in the decedent's gross income, the gain that the decedent elected to defer under section 1400Z–2(a) and the section 1400Z–2 regulations will be includable in the gross income, for the taxable year in which occurs an inclusion event, of the person described in section 691(a)(1).

(iv) *Qualifying investment in the hands of the person described in section 691(a)(1).* A qualifying investment received in a transfer by reason of death listed in paragraph (c)(4)(i) of this section continues to be a qualifying investment under § 1.1400Z2(a)–1(b)(34).

(5) *Grantor trusts*—(i) *Contributions to grantor trusts.* If the owner of a qualifying investment contributes it to a trust and, under subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code (grantor trust rules), the contributing owner of the investment is the deemed owner of the trust (grantor trust), the contribution to the grantor trust is not an inclusion event. Similarly, a transfer of the investment by the grantor trust to the trust's deemed owner is not an inclusion event. For all purposes of the section 1400Z–2 regulations, references to the term *grantor trust* mean the portion of the trust that holds the qualifying investment in the QOF, and such a grantor trust, or portion of the trust, is a wholly grantor trust as to the deemed owner. Such contributions may include transfers by gift or any other type of transfer between the grantor and the grantor trust that is a nonrecognition event as a result of the application of the grantor trust rules (that is, subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code).

(ii) *Changes in grantor trust status.* In general, a change in the income tax status of an existing trust owning a qualifying investment in a QOF, whether the termination of grantor trust status or the creation of grantor trust status, is an inclusion event. Notwithstanding the previous sentence, the termination of grantor trust status as the result of the death of the owner of a qualifying investment is not an inclusion event, but the provisions of paragraph (c)(4) of this section apply to distributions or dispositions by the trust. If a qualifying investment is held in the grantor portion of an electing small business trust (ESBT), as defined in section 1361(e)(1), and the ESBT converts into a qualified subchapter S trust (QSST), as defined in section 1361(d)(3), the beneficiary of which is the deemed owner of the grantor portion of the ESBT, there has been no change in the grantor trust status because the deemed owner continues to be taxable under subtitle A of the Code on the income and gain from the qualifying investment.

(iii) *Conversions of QSSTs and ESBTs.* With regard to conversions of QSSTs and ESBTs, see paragraphs (c)(7)(i)(B) and (C) of this section. For purposes of paragraph (c)(5)(ii) of this section, if a qualifying investment is held by a QSST that converts to an ESBT, the beneficiary of the QSST is the deemed owner of the grantor portion of the ESBT that then holds the qualifying investment, and the deemed owner is not a nonresident alien for purposes of this section (and thus notwithstanding § 1.1361–1(j)(8)), there has been no change in the grantor trust status because the deemed owner continues to be taxable under subtitle A of the Code on the income and gain from the qualifying investment.

(6) *Special rules for partners and partnerships*—(i) *Scope.* Except as otherwise provided in this paragraph (c)(6), in the case of a partnership that is a QOF or a QOF partner, the inclusion rules of this paragraph (c) apply to transactions involving any direct or indirect partner of the QOF to the extent of that partner's share of any eligible gain of the QOF.

(ii) *Transactions that are not inclusion events*—(A) *In general.* Notwithstanding paragraphs (c)(1) and (2) of this section, and except as otherwise provided in paragraph (c)(6) of this section, no transaction described in paragraph

(c)(6)(ii) of this section is an inclusion event.

(B) *Section 721 contributions*. Subject to paragraph (c)(6)(v) of this section, a contribution by a QOF owner (contributing partner), of its qualifying QOF stock, qualifying QOF partnership interest, or direct or indirect partnership interest in a qualifying investment to a partnership (transferee partnership) to the extent the transaction is governed by section 721(a) is not an inclusion event, provided the interest transfer does not cause a partnership termination of a QOF partnership, or the direct or indirect owner of a QOF, under section 708(b)(1). See paragraph (c)(6)(ii)(C) of this section for transactions governed by section 708(b)(2)(A). The inclusion rules in paragraph (c) of this section apply to any part of the transaction to which section 721(a) does not apply. The transferee partnership becomes subject to section 1400Z–2 and the section 1400Z–2 regulations with respect to the eligible gain associated with the contributed qualifying investment. The transferee partnership must allocate and report the remaining deferred gain that is associated with the contributed qualifying investment to the contributing partner to the same extent that the remaining deferred gain would have been allocated and reported to the contributing partner in the absence of the contribution. Additionally, the transferee partnership must allocate the basis increases described in section 1400Z–2(b)(2)(B)(iii) and (iv) to the contributing partner. If a transferee partnership is a direct QOF owner, only the transferee partnership may make the elections under section 1400Z–2(c) and the regulations in this part under section 1400Z–2(c) of the Code with respect to the contributed qualifying investment. See §1.1400Z2(c)–1(b)(1)(ii) (election by transferee partnership).

(C) *Section 708(b)(2)(A) mergers or consolidations—(1) Merger of a partnership that is a QOF partner*. Subject to paragraphs (c)(6)(iii) and (v) of this section, a merger or consolidation of a partnership that is a QOF partner (original partnership) with another partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event to the extent section 721(a) applies to the merger. To the extent the original partnership terminates in the merger, as determined under §1.708–1(c)(1), the partnership that is a continuation of the original partnership becomes subject to section 1400Z–2 and the section 1400Z–2 regulations to the same extent that the original partnership was so subject prior to the transaction, and must allocate and report any gain under section 1400Z–2(b) to the same extent and to the same partners that the original partnership allocated and reported such items prior to the transaction. Notwithstanding the rules in this paragraph (c)(6)(ii)(C)(*1*), the general inclusion rules of paragraph (c) of this section apply to the portion of the transaction that is otherwise treated as a sale or exchange under paragraph (c) of this section.

(*2*) *Merger of QOF partnerships*. Subject to paragraph (c)(6)(v) of this section, a merger or consolidation of a QOF partnership with another QOF partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event under paragraph (c)(2)(i) of this section if, immediately after the merger or consolidation, the resulting partnership is a QOF. The continuing partnership, as determined under §1.708–1(c)(1), becomes subject to section 1400Z–2 and the section 1400Z–2 regulations to the same extent that the terminated partnership was so subject prior to the transaction, and must allocate and report any gain under section 1400Z–2(b) to the same extent and to the same partners that the terminated partnership would have allocated and reported such items prior to the transaction. Notwithstanding the rules in this paragraph (c)(6)(ii)(C)(*2*), the general inclusion rules of paragraph (c) of this section apply to the portion of the transaction that is otherwise treated as a sale or exchange under paragraph (c) of this section.

(D) *Example*. The following example illustrates the rules of this paragraph (c)(6)(ii).

(*1*) *Example—(i) Facts*. In 2019, taxpayer A contributes $100 of eligible gain to a QOF partnership, X, in exchange for a qualifying QOF partnership interest in X, and taxpayer B contributes $100 of eligible gain to another QOF partnership, Y, in exchange for a qualifying QOF partnership interest in Y. In 2021, in transactions governed by section 721(a), A

contributes her qualifying QOF partnership interest in X, and B contributes her qualifying QOF partnership interest in Y, to a newly formed partnership, UTP. In 2024, C receives a profits interest in UTP for services that she will provide to UTP. In 2031, X sells a non-inventory asset and allocates X's distributive share of the gain to UTP. No distributions are ever made from X, Y, or UTP.

(*ii*) *Analysis*. On December 31, 2026, UTP recognizes $170 of remaining deferred gain relating to the QOF interests. Of that gain, A is allocated the $85 of gain relating to the $100 of eligible gain that she invested in X, and B is allocated the $85 of gain relating to the $100 of eligible gain that she invested in Y. C recognizes no gain at this time. In 2031, because UTP's holding period in X includes A's holding period in X, UTP has a holding period in X that exceeds 10 years, and may make an election under §1.1400Z2(c)–1(b)(2)(ii) to exclude the gain from X's asset sale. Even though A was the original investor in X, she may not make the election. If UTP makes the election, UTP will exclude its distributive share of gain from the sale of the X asset.

(*2*) [Reserved]

(iii) *Partnership distributions*. Subject to paragraph (c)(6)(v) of this section, an actual or deemed distribution of property, including cash, by a QOF partnership to a partner with respect to its qualifying investment is an inclusion event only to the extent that the distributed property has a fair market value in excess of the partner's basis in its qualifying investment. For purposes of this paragraph (c)(6)(iii), in the case of a merger or consolidation of a QOF partnership with another QOF partnership in a transaction to which section 708(b)(2)(A) applies, the fair market value of the distributed property is reduced by the fair market value of the QOF partnership interest received in the merger or consolidation. A distribution from a partnership that directly or indirectly owns a QOF is an inclusion event only if the distribution is a liquidating distribution. For purposes of this paragraph (c)(6)(iii), the distribution is not in complete liquidation if the partnership making the distribution is a partnership that terminates in a partnership merger or consolidation under §1.708–1(c), the continuing partnership in the merger or consolidation continues to directly or indirectly own an interest in the QOF, and the distributee is distributed an interest in the resulting partnership as part of the merger or consolidation. See paragraph (c)(6)(iv) of this section for special rules relating to mixed-funds investments.

(iv) *Special rules for mixed-funds investments*—(A) *In general*. The rules of this paragraph (c)(6)(iv) apply solely for purposes of section 1400Z–2. A partner that holds a mixed-funds investment in a QOF partnership (a mixed-funds partner) shall be treated as holding two separate interests in the QOF partnership, one a qualifying investment and the other a non-qualifying investment (separate interests). The basis of each separate interest is determined under the rules described in paragraphs (c)(6)(iv)(B) and (g) of this section as if each interest were held by different taxpayers.

(B) *Allocations and distributions*. All section 704(b) allocations of income, gain, loss, and deduction, all section 752 allocations of debt, and all distributions made to a mixed-funds partner will be treated as made to the separate interests based on the allocation percentages of those interests as defined in paragraph (c)(6)(iv)(D) of this section. For purposes of this paragraph (c)(6)(iv)(B), in allocating income, gain, loss, or deduction between these separate interests, section 704(c) principles apply to account for any value-basis disparities attributable to the qualifying investment or non-qualifying investment. Any distribution (whether actual or deemed) to the holder of a qualifying investment is subject to the rules of paragraphs (c)(6)(iii) and (v) of this section, without regard to the presence or absence of gain under other provisions of subchapter K of chapter 1 of subtitle A of the Internal Revenue Code.

(C) *Subsequent contributions*. In the event of an increase in a partner's qualifying or non-qualifying investment, as for example, in the case of an additional contribution for a qualifying investment or for an interest that is a non-qualifying investment or a change in allocations for services rendered, the partner's interest in the separate interests must be valued immediately prior to the event and the

allocation percentages adjusted to reflect the relative values of these separate interests and the additional contribution, if any.

(D) *Allocation percentages*. The allocation percentages of the separate interests will be determined based on the relative capital contributions attributable to the qualifying investment and the non-qualifying investment. In the event a partner receives a profits interest in the QOF partnership for services provided to or for the benefit of the QOF partnership, the allocation percentage with respect to the profits interest is based on the share of residual profits the mixed-funds partner would receive with respect to that interest, disregarding any allocation of residual profits for which there is not a reasonable likelihood of application.

(E) *Examples*. The following examples illustrate the rules of this paragraph (c)(6)(iv).

(*1*) *Example 1. Allocation of residual profits for which there is no reasonable likelihood of application*—(*i*) *Facts*. A realizes $100 of eligible gain and B realizes $900 of eligible gain. A and B form Q, a QOF partnership. B contributes $900 to Q in exchange for a qualifying QOF partnership interest (B's capital interest). A contributes $100 to Q in exchange for a qualifying QOF partnership interest (A's capital interest and, with B's capital interest, the capital interests) and agrees to provide services to Q in exchange for a profits interest in Q (A's profits interest). Q's partnership agreement provides that Q's profits are first allocated to the capital interests until the capital interest holders receive a 10 percent preferred return with respect to those interests. Next, Q's profits are allocated 15 percent to A with respect to A's profits interest, 10 percent to A with respect to A's capital interest, and 75 percent to B until the capital interests receive a 1,000% preferred return. Thereafter, Q's profits are allocated 1 percent to A's profits interest and 99 percent to the capital interests. There is not a reasonable likelihood that Q's profits will be sufficient to result in an allocation in the last tranche.

(*ii*) *Analysis*. Under paragraph (c)(6)(iv)(D) of this section, the allocation percentage with respect to A's profits interest is calculated based on the share of residual profits that A would receive with respect to A's profits interest, disregarding any allocation of residual profits that has no reasonable likelihood of being achieved. Under Q's partnership agreement, A's share of Q's residual profits with respect to A's profits interest is 1 percent. However, there is no reasonable likelihood that this 1 percent allocation will apply because it is unlikely that the capital interests will receive a 1,000% preferred return. Therefore, under paragraph (c)(6)(iv)(D) of this section, A's share of Q's residual profits with respect to A's profits interest is 15 percent, the final allocation of Q's profits to A's profits interest that is reasonably likely to apply. The allocation percentage for A's capital interest in Q is 10 percent under paragraph (c)(6)(iv)(D) of this section. Thus, allocations and distributions made to A are treated as made 60 percent (15/25) to A's nonqualifying profits interest and 40 percent (10/25) to A's qualifying QOF partnership interest.

(*2*) *Example 2. Separate entity holding profits interest*—(i) *Facts*. The facts are the same as in paragraph (c)(6)(iv)(E)(*1*) of this section (*Example 1*), except that A is a partnership that has no eligible gain and P, a partnership that is owned by the same taxpayers who own A, realizes $100 of eligible gain and contributes $100 to Q for its qualifying investment.

(*ii*) *Analysis*. Under paragraph (c)(6)(iv)(D) of this section, A's profits interest is a nonqualifying investment in Q. Because P directly holds only a qualifying QOF partnership interest in Q, P is not a mixed-funds partner in Q, and 100 percent of the allocations and distributions made to P are attributable to P's qualifying QOF partnership interest.

(v) *Remaining deferred gain reduction rule*. An inclusion event occurs when and to the extent that a transaction has the effect of reducing:

(A) The amount of remaining deferred gain of one or more direct or indirect partners; or

(B) The amount of gain that would be recognized by such partner or partners under paragraph (e)(4)(ii) of this section to the extent that such amount would reduce such gain to an amount that is less than the remaining deferred gain.

(7) *Special rules for S corporations*—(i) *In general*. Except as provided in paragraphs (c)(7)(ii), (iii), and (iv) of this section, none of the following is an inclusion event:

(A) An election, revocation, or termination of a corporation's status as an S corporation under section 1362;

(B) A conversion of a QSST to an ESBT, but only if the QSST beneficiary is the deemed owner of the grantor portion of the ESBT that receives the qualifying investment and if the deemed owner is not a nonresident alien;

(C) A conversion of an ESBT to a QSST, where the qualifying investment is held in the grantor portion of the ESBT and the QSST beneficiary is the deemed owner of the grantor portion of the ESBT; and

(D) A valid modification of a trust agreement of an S-corporation shareholder whether by an amendment, a decanting, a judicial reformation, or a material modification.

(ii) *Distributions by QOF S corporation*—(A) *General rule.* An actual or constructive distribution of property by a QOF S corporation to a QOF shareholder with respect to its qualifying investment is an inclusion event to the extent that the distribution is treated as gain from the sale or exchange of property under section 1368(b)(2) and (c). For the treatment of a distribution by a QOF S corporation to which section 305(a) applies, see paragraph (c)(8)(ii). For the treatment of a distribution to which section 302(d) or section 306(a)(2) applies, see paragraph (c)(9)(ii) of this section.

(B) *Spill-over rule.* For purposes of applying paragraph (c)(7)(ii) of this section to the adjusted basis of a qualifying investment, or non-qualifying investment, as appropriate, in a QOF S corporation, the second sentence of § 1.1367–1(c)(3) applies—

(*1*) With regard to multiple qualifying investments, solely to the respective bases of such qualifying investments, and does not take into account the basis of any non-qualifying investment; and

(*2*) With regard to multiple non-qualifying investments, solely to the respective bases of such non-qualifying investments, and does not take into account the basis of any qualifying investment.

(iii) *Conversion from S corporation to partnership or disregarded entity*—(A) *General rule.* Notwithstanding paragraph (c)(7)(i) of this section, and except as provided in paragraph (c)(7)(iii)(B) of this section, a conversion of an S corporation to a partnership or an entity disregarded as separate from its owner under § 301.7701–3(b)(1)(ii) of this chapter is an inclusion event.

(B) *Exception for qualifying section 381 transaction.* A conversion described in paragraph (c)(7)(iii)(A) of this section is not an inclusion event if the conversion comprises a step in a series of related transactions that together qualify as a qualifying section 381 transaction.

(iv) *Treatment of separate blocks of stock in mixed-funds investments.* With regard to a mixed-funds investment in a QOF S corporation, if different blocks of stock are created for separate qualifying investments to track basis in such qualifying investments, the separate blocks are not treated as different classes of stock for purposes of S corporation eligibility under section 1361(b)(1).

(v) *Applicability.* Paragraph (c)(7) of this section applies regardless of whether the S corporation is a QOF or a QOF shareholder.

(8) *Distributions by a QOF corporation*—(i) *General rule for distributions by a QOF C corporation.* If a QOF C corporation distributes property to a QOF shareholder with respect to a qualifying investment, only the amount of the distribution to which section 301(c)(3) or 1059(a)(2) applies gives rise to an inclusion event. For purposes of this paragraph (c)(8)(i), a distribution of property includes a distribution of stock in the QOF C corporation making the distribution (or rights to acquire such stock) if the distribution is treated as a distribution of property to which section 301 applies pursuant to section 305(b).

(ii) *Section 305(a) distributions.* A distribution with respect to qualifying QOF stock to which section 305(a) applies is not an inclusion event. QOF stock received in such a distribution is qualifying QOF stock. The shareholder's remaining deferred gain is allocated pro rata between the new qualifying QOF stock received and the qualifying QOF stock with respect to which the distribution was made in proportion to the fair market values of each on the date of distribution. See § 1.307–1(a).

(9) *Dividend-equivalent redemptions and redemptions of section 306 stock.*—(i) *Redemptions by QOF C corporations*—(A) *In general.* Except as provided in paragraph (c)(9)(i)(B) of this section, if a QOF C corporation redeems its stock

from a QOF shareholder in a transaction described in section 302(d) or section 306(a)(2), the full amount of such redemption gives rise to an inclusion event.

(B) *Redemptions of stock of wholly owned QOF C corporation and pro rata redemptions.* Paragraph (c)(8)(i) of this section applies to a redemption described in paragraph (c)(9)(i)(A) of this section if, at the time of such redemption—

(*1*) All stock in the QOF C corporation is held directly by a single shareholder, or directly by members of a single consolidated group; or

(*2*) The QOF C corporation has outstanding only one class of stock, as defined in section 1361 and §1.1361–1(l), and the redemption is pro rata as to all shareholders of the redeeming QOF C corporation.

(ii) *Redemptions by QOF S corporations.* If a QOF S corporation redeems its stock from a QOF shareholder in a transaction described in section 302(d) or section 306(a)(2), the amount that gives rise to an inclusion event is the amount by which the distribution exceeds basis in the QOF stock as adjusted under paragraph (c)(7)(ii) of this section.

(10) *Qualifying section 381 transactions*—(i) *Assets of a QOF are acquired*—(A) *In general.* Except to the extent provided in paragraph (c)(10)(i)(C) of this section, if the assets of a QOF corporation are acquired in a qualifying section 381 transaction, and if the acquiring corporation is a QOF immediately after the acquisition, then the transaction is not an inclusion event.

(B) *Determination of acquiring corporation's status as a QOF.* For purposes of paragraph (c)(10)(i)(A) of this section, the acquiring corporation is treated as a QOF immediately after the qualifying section 381 transaction if the acquiring corporation satisfies the certification requirements in §1.1400Z2(d)–1 immediately after the transaction and holds at least 90 percent of its assets in qualified opportunity zone property on the first testing date after the transaction. See section 1400Z–2(d)(1) and §1.1400Z2(d)–1.

(C) *Receipt of boot by QOF shareholder in qualifying section 381 transaction.* This paragraph (c)(10)(i)(C) applies if assets of a QOF corporation are acquired in a qualifying section 381 transaction and an eligible taxpayer that is a QOF shareholder receives boot with respect to its qualifying investment. If this paragraph (c)(10)(i)(C) applies, the QOF shareholder has an inclusion event and is treated as disposing of a portion of its qualifying investment that bears the same proportion to the QOF shareholder's total qualifying investment immediately before the inclusion event as the fair market value of the boot received by the QOF shareholder with respect to its qualifying investment in the qualifying section 381 transaction bears to the fair market value of the total consideration received by the QOF shareholder with respect to its qualifying investment in the qualifying section 381 transaction.

(ii) *Assets of a QOF shareholder are acquired*—(A) *In general.* Except to the extent provided in paragraph (c)(10)(ii)(B) of this section, a qualifying section 381 transaction in which the assets of a QOF shareholder are acquired is not an inclusion event with respect to the qualifying investment and the acquiring corporation succeeds to the target corporation's status as the QOF shareholder with respect to the qualifying investment.

(B) *Qualifying section 381 transaction in which QOF shareholder's qualifying investment is not completely acquired.* If the assets of a QOF shareholder are acquired in a qualifying section 381 transaction in which the acquiring corporation does not acquire all of the QOF shareholder's qualifying investment, the QOF shareholder has an inclusion event and is treated as disposing of the portion of its qualifying investment that is not transferred to the acquiring corporation.

(11) *Section 355 transactions*—(i) *Distribution by a QOF*—(A) *In general.* Except as provided in paragraph (c)(11)(i)(B) of this section, if a QOF corporation distributes stock or securities of a controlled corporation to a QOF shareholder with respect to a qualifying investment in the QOF corporation in a transaction to which section 355 (or so much of section 356 as relates to section 355) applies, the QOF shareholder has an inclusion event and is treated as disposing of a portion of

its qualifying investment equal in value to the fair market value of the shares of the controlled corporation and the fair market value of any boot received by the QOF shareholder in the distribution with respect to its qualifying investment.

(B) *Controlled corporation becomes a QOF*—(*1*) *In general*. Except as provided in paragraph (c)(11)(i)(B)(*3*) of this section, if a QOF corporation distributes stock or securities of a controlled corporation in a transaction to which section 355, or so much of section 356 as relates to section 355, applies, and if both the distributing corporation and the controlled corporation are QOFs immediately after the final distribution (qualifying section 355 transaction), then the distribution is not an inclusion event with respect to a QOF shareholder's qualifying investment in the distributing QOF corporation or the controlled QOF corporation. This paragraph (c)(11)(i)(B) does not apply unless the distributing corporation distributes all of the stock and securities in the controlled corporation held by it immediately before the distribution within a 30-day period. For purposes of this paragraph (c)(11)(i)(B), the term *final distribution* means the last distribution that satisfies the preceding sentence.

(*2*) *Determination of distributing corporation's and controlled corporation's status as QOFs*. For purposes of paragraph (c)(11)(i)(B)(*1*) of this section, each of the distributing corporation and the controlled corporation is treated as a QOF immediately after the final distribution if the corporation satisfies the certification requirements in §1.1400Z2(d)–1 immediately after the final distribution and holds at least 90 percent of its assets in qualified opportunity zone property on the first testing date after the final distribution. See section 1400Z–2(d)(1) and §1.1400Z2(d)–1.

(*3*) *Receipt of boot*. If a QOF shareholder receives boot in a qualifying section 355 transaction with respect to its qualifying investment, and if section 356(a) applies to the transaction, paragraph (c)(10)(i)(C) of this section applies. If a QOF shareholder receives boot in a qualifying section 355 transaction with respect to its qualifying investment, and if section 356(b) applies to the transaction, paragraph (c)(8)(i) of this section applies.

(*4*) *Treatment of controlled corporation stock as qualified opportunity zone stock*. If stock or securities of a controlled corporation are distributed in a qualifying section 355 transaction, and if the distributing corporation retains a portion of the controlled corporation stock after the initial distribution, the retained stock will not cease to qualify as qualified opportunity zone stock in the hands of the distributing corporation solely as a result of the qualifying section 355 transaction. This paragraph (c)(11)(i)(B)(*4*) does not apply unless the distributing corporation distributes all of the stock and securities in the controlled corporation held by it immediately before the distribution within a 30-day period.

(ii) *Distribution by a QOF shareholder*. If a QOF shareholder distributes stock or securities of a controlled QOF corporation in a transaction to which section 355 applies, then for purposes of section 1400Z–2(b)(1) and paragraph (b) of this section, the QOF shareholder has an inclusion event and is treated as disposing of the portion of its qualifying QOF stock over which it no longer has direct Federal income tax ownership.

(12) *Recapitalizations and section 1036 transactions*—(i) *In general*. Except as otherwise provided in paragraph (c)(12)(ii) of this section, if a QOF corporation engages in a transaction that qualifies as a reorganization described in section 368(a)(1)(E) (a recapitalization), or if a QOF shareholder engages in a transaction that is described in section 1036 (a section 1036 exchange), the transaction is not an inclusion event.

(ii) *Receipt of property or boot by QOF shareholder*. If a QOF shareholder receives property or boot, or is treated as having received property or boot, with respect to its qualifying investment in a recapitalization, then the property or boot is treated as property or boot to which section 301 or section 356(a) or (c) applies, as determined under general Federal income tax principles. If, in a section 1036 exchange, a QOF shareholder receives property with respect to its qualifying investment that

is not permitted to be received without the recognition of gain, then, for purposes of this section, the receipt of the property is treated in a similar manner as the receipt of such property or boot in a recapitalization. Paragraph (c)(8)(i) of this section applies to property to which section 301 applies. Paragraph (c)(10)(i)(C) of this section applies to boot to which section 356(a) or (c) applies.

(13) *Section 304 transactions.* If a QOF shareholder transfers its qualifying investment in a transaction described in section 304(a), the full amount of the consideration gives rise to an inclusion event.

(14) *Deduction for worthlessness.* If an eligible taxpayer claims a loss for worthless stock under section 165(g) or otherwise claims a worthlessness deduction with respect to all or a portion of its qualifying investment, then for purposes of section 1400Z–2 and the section 1400Z–2 regulations, the eligible taxpayer has an inclusion event and is treated as having disposed of that portion of its qualifying investment on the date it became worthless. Thus, neither section 1400Z–2(b)(2)(B)(iii) or (iv) nor section 1400Z–2(c) applies to that portion of the eligible taxpayer's qualifying investment after the date it became worthless.

(15) *Decertification of a QOF.* The decertification of a QOF, whether a self-decertification pursuant to §1.1400Z2(d)–1(a)(3) or an involuntary decertification pursuant to §1.1400Z2(d)–1(a)(4), is an inclusion event.

(16) *Other inclusion and non-inclusion events.* Notwithstanding any other provision of this paragraph (c), the Commissioner may determine in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) that a type of transaction is or is not an inclusion event.

(d) *Holding periods*—(1) *Holding period for qualifying investment*—(i) *In general.* Solely for purposes of section 1400Z–2(b)(2)(B), section 1400Z–2(c), and the section 1400Z–2 regulations, and except as otherwise provided in this paragraph (d)(1), the length of time a qualifying investment has been held is determined without regard to the period for which the eligible taxpayer had held property exchanged for such investment (even if such period would be relevant for determining the length of time for other Federal income tax purposes).

(ii) *Holding period for qualifying investment received in certain transactions with respect to QOFs.* For purposes of section 1400Z–2(b)(2)(B), section 1400Z–2(c), and the section 1400Z–2 regulations, the principles of section 1223(1) or (4) apply to determine the holding period for a qualifying investment received by a QOF owner in—

(A) A distribution described in paragraph (c)(2)(ii)(B) of this section;

(B) A distribution to which section 305(a) applies;

(C) A qualifying section 381 transaction described in paragraph (c)(10)(i) or (ii) of this section;

(D) A qualifying section 355 transaction described in paragraph (c)(11)(i)(B) of this section;

(E) A recapitalization or a section 1036 exchange described in paragraph (c)(12) of this section;

(F) A contribution of a QOF interest to a partnership to the extent section 721(a) applies to the transfer; or

(G) A distribution of a QOF interest to the extent the interest was received in a merger of two or more QOF partnerships in a transaction described in section 708(b)(2)(A).

(iii) *Tacking with deceased owner or deemed owner of a grantor trust.* For purposes of section 1400Z–2(b)(2)(B), section 1400Z–2(c), and the section 1400Z–2 regulations, the holding period of a qualifying investment held by an eligible taxpayer who received that qualifying investment by reason of the prior owner's death includes the time during which that qualifying investment was held by the deceased owner. The rule in the preceding sentence also applies to allow a grantor trust to tack the holding period of the deemed owner if the grantor trust acquires the qualifying investment from the deemed owner in a transaction that is not an inclusion event.

(2) *Status of QOF assets as qualified opportunity zone property.* For purposes of section 1400Z–2(d) and the section 1400Z–2 regulations, including for purposes of determining whether the original use of qualified opportunity zone business property commences with the

acquiring corporation or partnership, qualified opportunity zone property does not lose its status as qualified opportunity zone property solely as a result of—

(i) Its transfer by the transferor corporation to the acquiring corporation in a qualifying section 381 transaction described in paragraph (c)(10)(i) of this section;

(ii) Its transfer by the distributing corporation to the controlled corporation in a qualifying section 355 transaction described in paragraph (c)(11)(i)(B) of this section; or

(iii) Its transfer by the transferor partnership to the acquiring partnership in a transaction to which section 708(b)(2)(A) applies, but only to the extent section 721(a) applies to the transaction.

(e) *Amount includible.* Except as provided in §§ 1.1400Z2(a)–1(b)(7) and 1.1400Z2(f)–1(b), the amount of gain included in gross income under section 1400Z–2(a)(1)(B) and this section on a date described in paragraph (b) of this section is determined under this paragraph (e).

(1) *In general.* Except as provided in paragraphs (e)(2) and (4) of this section, and subject to paragraph (e)(5) of this section, in the case of an inclusion event, the amount of gain included in gross income is equal to the excess of the amount described in paragraph (e)(1)(i) of this section over the eligible taxpayer's basis in the portion of the qualifying investment that is disposed of in the inclusion event. See paragraph (c) of this section for rules regarding the amount that gave rise to the inclusion event, and see paragraph (g) of this section for applicable ordering rules.

(i) The amount described in this paragraph (e)(1)(i) is equal to the lesser of—

(A) An amount which bears the same proportion to the remaining deferred gain, as—

(*1*) The fair market value of the portion of the qualifying investment that is disposed of in the inclusion event bears to—

(*2*) The fair market value of the total qualifying investment immediately before the inclusion event; or

(B) The fair market value of the portion of the qualifying investment that is disposed of in the inclusion event.

(ii) For purposes of paragraph (e)(1)(i) of this section, the fair market value of the portion of the qualifying investment that is disposed of in the inclusion event is determined by multiplying the fair market value of the eligible taxpayer's entire qualifying investment in the QOF, determined as of the date of the inclusion event, by the percentage of the eligible taxpayer's qualifying investment that is represented by the portion that is disposed of in the inclusion event.

(2) *Property received from a QOF in certain transactions.* In the case of an inclusion event described in paragraph (c)(6)(iii) or (v), (c)(7)(ii), (c)(8)(i), or (c)(9) or (13) of this section (or in paragraph (c)(11) or (12) of this section, to the extent the rules in paragraph (c)(8)(i) of this section apply to the inclusion event), the amount of gain included in gross income is equal to the lesser of—

(i) The remaining deferred gain; or

(ii) The amount that gave rise to the inclusion event.

(3) *Gain recognized on December 31, 2026.* The amount of gain included in gross income on December 31, 2026 is equal to the excess of—

(i) The lesser of—

(A) The remaining deferred gain; and

(B) The fair market value of the qualifying investment held on December 31, 2026; over

(ii) The eligible taxpayer's basis in the qualifying investment as of December 31, 2026, taking into account only section 1400Z–2(b)(2)(B).

(4) *Special amount includible rule for partnerships and S corporations.* For purposes of paragraphs (e)(1) and (3) of this section, in the case of an inclusion event involving a qualifying investment in a QOF partnership or S corporation, or in the case of a qualifying investment in a QOF partnership or S corporation held on December 31, 2026, the amount of gain included in gross income is equal to the lesser of—

(i) The product of—

(A) The percentage of the qualifying investment that gave rise to the inclusion event; and

(B) The remaining deferred gain, less any basis adjustments pursuant to section 1400Z–2(b)(2)(B)(iii) and (iv); or

(ii) The gain that would be recognized on a fully taxable disposition at fair market value of the qualifying investment that gave rise to the inclusion event.

(5) *Limitation on amount of gain included after statutory five-year and seven-year basis increases*. The total amount of gain included in gross income under this paragraph (e) is limited to the amount deferred under section 1400Z–2(a)(1) and the section 1400Z–2 regulations, reduced by any increase in the basis of the qualifying investment made pursuant to section 1400Z–2(b)(2)(B)(iii) and (iv). See paragraph (g)(2) of this section for limitations on the amount of basis adjustments under section 1400Z–2(b)(2)(B)(iii) and (iv).

(f) *Examples*. The following examples illustrate the rules of paragraphs (c), (d) and (e) of this section. For purposes of the following examples: A, B, C, W, X, Y, and Z are C corporations that do not file a consolidated Federal income tax return; Q is a QOF corporation or a QOF partnership, as specified in each example; and each divisive corporate transaction satisfies the requirements of section 355.

(1) *Example 1. Determination of basis, holding period, and qualifying investment* —(i) *Facts*. A wholly and directly owns Q, a QOF corporation. On May 31, 2019, A sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A transfers unencumbered asset N to Q in exchange for a qualifying investment. Asset N, which A has held for 10 years, has a basis of $500 and a fair market value of $500. A elects to defer the inclusion of $500 in gross income under section 1400Z–2(a) and § 1.1400Z2(a)–1.

(ii) *Analysis*. Under § 1.1400Z2(a)–1(c)(6)(ii)(B)(*1*), A made a qualifying investment of $500. Under section 1400Z–2(b)(2)(B)(i), A's basis in its qualifying investment in Q is $0. For purposes of sections 1400Z–2(b)(2)(B) and 1400Z–2(c), A's holding period in its new investment in Q begins on October 31, 2019. See paragraph (d)(1)(i) of this section. Other than for purposes of applying section 1400Z–2, A has a 10-year holding period in its new Q investment as of October 31, 2019.

(iii) *Transfer of built-in gain property*. The facts are the same as in paragraph (f)(1)(i) of this section (this *Example 1*), but A's basis in transferred asset N is $200. Under § 1.1400Z2(a)–1(c)(6)(ii)(B)(*1*), A made a qualifying investment of $200 and a non-qualifying investment of $300.

(2) *Example 2. Transfer of qualifying investment*—(i) *Facts*. On May 31, 2019, taxpayer A sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A transfers $500 to newly formed Q, a QOF corporation, in exchange for a qualifying investment. On February 29, 2020, A transfers 25 percent of its qualifying investment in Q to newly formed Y in exchange for 100 percent of Y's stock in a transfer to which section 351 applies (Transfer), at a time when the fair market value of A's qualifying investment in Q is $800.

(ii) *Analysis*. Under § 1.1400Z2(a)–1(c)(6)(ii)(A), A made a qualifying investment of $500 on October 31, 2019. In the Transfer, A exchanged 25 percent of its qualifying investment for Federal income tax purposes, which reduced A's direct qualifying investment. Under paragraph (c)(1)(i) of this section, the Transfer is an inclusion event to the extent of the reduction in A's direct qualifying investment. Under paragraph (e)(1) of this section, A therefore includes in income an amount equal to the excess of the amount described in paragraph (e)(1)(i) of this section over A's basis in the portion of the qualifying investment that was disposed of, which in this case is $0. The amount described in paragraph (e)(1)(i) is the lesser of $125 ($500 × ($200/$800)) or $200. As a result, A must include $125 of its deferred capital gain in income in 2020. After the Transfer, the Q stock is not qualifying Q stock in Y's hands.

(iii) *Disregarded transfer*. The facts are the same as in paragraph (f)(2)(i) of this section (this *Example 2*), except that Y elects to be treated as an entity that is disregarded as an entity separate from its owner for Federal income tax purposes effective prior to the Transfer. Since the Transfer is disregarded for Federal income tax purposes, A's transfer of its qualifying investment in Q is not treated as a reduction in direct tax ownership for Federal income tax purposes, and the Transfer is not an inclusion event with respect to A's qualifying investment in Q for purposes of section 1400Z–2(b)(1) and paragraph (b) of this section. Thus, A is not required to include in income any portion of its deferred capital gain.

(iv) *Election to be treated as a corporation*. The facts are the same as in paragraph (f)(2)(iii) of this section (this *Example 2*), except that Y (a disregarded entity) subsequently elects to be treated as a corporation for Federal income tax purposes. A's deemed transfer of its qualifying investment in Q to Y under § 301.7701–3(g)(1)(iv) of this chapter is an inclusion event for purposes of section 1400Z–2(b)(1) and paragraph (b) of this section.

(3) *Example 3. Part sale of qualifying QOF partnership interest in Year 6 when value of the QOF partnership interest has increased*—(i)

Facts. In October 2018, A and B each realize $200 of eligible gain, and C realizes $600 of eligible gain. On January 1, 2019, A, B, and C form Q, a QOF partnership. A contributes $200 of cash, B contributes $200 of cash, and C contributes $600 of cash to Q in exchange for qualifying QOF partnership interests in Q. A, B, and C hold 20 percent, 20 percent, and 60 percent interests in Q, respectively. On January 30, 2019, Q obtains a nonrecourse loan from a bank for $1,000. Under section 752, the loan is allocated $200 to A, $200 to B, and $600 to C. On February 1, 2019, Q purchases qualified opportunity zone business property for $2,000. On July 31, 2024, A sells 50 percent of its qualifying QOF partnership interest in Q to B for $400 cash. Prior to the sale, there were no inclusion events, distributions, partner changes, income or loss allocations, or changes in the amount or allocation of debt outstanding. At the time of the sale, the fair market value of Q's qualified opportunity zone business property is $5,000.

(ii) *Analysis*. Because A held its qualifying QOF partnership interest for at least five years, A's basis in its partnership interest at the time of the sale is $220 (the original zero basis with respect to the contribution, plus the $200 debt allocation, plus the 10% increase for interests held for five years). The sale of 50 percent of A's qualifying QOF partnership interest to B requires A to recognize $90 of gain, the lesser of $90, which is 50 percent of $180 (the $200 remaining deferred gain less the $20 five-year basis adjustment), or $390, which is the gain that would be recognized on a taxable sale of 50 percent of the interest. A also recognizes $300 of gain relating to the appreciation of its interest in Q.

(4) *Example 4. Sale of qualifying QOF partnership interest when value of the QOF partnership interest has decreased*—(i) *Facts*. The facts are the same as in paragraph (f)(3) of this section (*Example 3*), except that A sells 50 percent of its qualifying QOF partnership interest in Q to B for cash of $50, and at the time of the sale, the fair market value of Q's qualified opportunity zone business property is $1,500.

(ii) *Analysis*. Because A held its qualifying QOF partnership interest for at least five years, A's basis at the time of the sale is $220. Under section 1400Z–2(b)(2)(A), the sale of 50 percent of A's qualifying QOF partnership interest to B requires A to recognize $40 of gain, the lesser of $90 (50 percent of the excess of A's $200 remaining deferred gain over A's $20 five-year adjustment) or $40 (the gain that would be recognized by A on a sale of 50 percent of its QOF interest). A's remaining basis in its qualifying QOF partnership interest is $110.

(5) *Example 5. Amount includible on December 31, 2026*—(i) *Facts*. The facts are the same as in paragraph (f)(3) of this section (*Example 3*), except that no sale of QOF interests takes place in 2024. Prior to December 31, 2026, there were no inclusion events, distributions, partner changes, income or loss allocations, or changes in the amount or allocation of debt outstanding.

(ii) *Analysis*. For purposes of calculating the amount includible on December 31, 2026, each of A's basis and B's basis is increased by $30 to $230, and C's basis is increased by $90 to $690 because they held their qualifying QOF partnership interests for at least seven years. Each of A and B is required to recognize $170 of gain, and C is required to recognize $510 of gain.

(iii) *Sale of qualifying QOF partnership interests*. The facts are the same as in paragraph (f)(5)(i) of this section (this *Example 5*), except that, on March 2, 2030, C sells its entire qualifying QOF partnership interest in Q to an unrelated buyer for cash of $4,200. Assuming an election under section 1400Z–2(c) is made, the basis of C's Q interest is increased to its fair market value immediately before the sale by C. C is treated as purchasing the interest immediately before the sale and the bases of the partnership's assets are increased in the manner they would be if the partnership had an election under section 754 in effect.

(6) *Example 6. Mixed-funds investment*—(i) *Facts*. On January 1, 2019, A and B form Q, a QOF partnership. A contributes $200 to Q, $100 of which is in exchange for a qualifying investment, and B contributes $200 to Q in exchange for a qualifying investment. All the cash is used to purchase qualified opportunity zone property. Q has no liabilities. On March 30, 2023, when the values and bases of the qualifying investments remain unchanged, Q distributes $50 to A.

(ii) *Analysis*. Under paragraph (c)(6)(iv) of this section, A is a mixed-funds partner holding two separate interests, a qualifying investment and a non-qualifying investment. One half of the $50 distribution is treated under that provision as being made with respect to A's qualifying investment. For the $25 distribution made with respect to the qualifying investment, A is required to recognize $25 of gain.

(iii) *Basis adjustments*. Under paragraph (g)(1)(ii)(B) of this section, prior to determining the tax consequences of the distribution, A increases its basis in its qualifying QOF partnership interest by $25 under section 1400Z–2(b)(2)(B)(ii). The distribution of $25 results in no gain under section 731. After the distribution, A's basis in its qualifying QOF partnership interest is $0 ($25 − $25).

(7) *Example 7. Qualifying section 381 transaction of a QOF corporation*—(i) *Facts*. X wholly and directly owns Q, a QOF corporation. On May 31, 2019, X sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, X contributes $500 to Q in exchange for a qualifying investment. In 2020, Q merges with and into unrelated Y

(with Y surviving) in a transaction that qualifies as a reorganization under section 368(a)(1)(A) (Merger). X does not receive any boot in the Merger with respect to its qualifying investment in Q. Immediately after the Merger, Y satisfies the requirements for QOF status under section 1400Z–2(d)(1) (see paragraph (c)(10)(i)(B) of this section).

(ii) *Analysis*. The Merger is not an inclusion event for purposes of section 1400Z–2(b)(1) and paragraph (b) of this section. See paragraph (c)(10)(i)(A) of this section. Accordingly, X is not required to include in income in 2020 its $500 of deferred capital gain as a result of the Merger. For purposes of section 1400Z–2(b)(2)(B) and (c), X's holding period for its investment in Y is treated as beginning on October 31, 2019. For purposes of section 1400Z–2(d), Y's holding period in its assets includes Q's holding period in its assets, and Q's qualified opportunity zone business property continues to qualify as such. See paragraph (d)(2) of this section.

(iii) *Merger of QOF shareholder*. The facts are the same as in paragraph (f)(7)(i) of this section (this *Example 7*), except that, in 2020, X (rather than Q) merges with and into Y in a section 381 transaction in which Y acquires all of X's qualifying investment in Q, and Y does not qualify as a QOF immediately after the merger. The merger transaction is not an inclusion event for purposes of section 1400Z–2(b)(1) and paragraph (b) of this section. See paragraph (c)(10)(ii) of this section.

(iv) *Receipt of boot*. The facts are the same as in paragraph (f)(7)(i) of this section (this *Example 7*), except that the value of X's qualifying investment immediately before the Merger is $1,000, X receives $100 of cash in addition to Y stock with a fair market value of $900 in the Merger in exchange for its qualifying investment, and neither Q nor Y has any earnings and profits. Under paragraph (c)(10)(i)(C) of this section, X is treated as disposing of 10 percent ($100/$1000) of its qualifying investment. Under paragraph (e)(1) of this section, X is required to include $50 ($500 × ($100/$1000)) of its deferred capital gain in income in 2020.

(8) *Example 8. Section 355 distribution by a QOF*—(i) *Facts*. A wholly and directly owns Q, a QOF corporation, which wholly and directly owns Y, a corporation that is a qualified opportunity zone business. On May 31, 2019, A sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A contributes $500 to Q in exchange for a qualifying investment. On June 26, 2025, Q distributes all of the stock of Y to A in a transaction in which no gain or loss is recognized under section 355 (Distribution). Immediately after the Distribution, each of Q and Y satisfies the requirements for QOF status. (See paragraph (c)(11)(i)(B)(*2*) of this section.)

(ii) *Analysis*. Because each of Q, the distributing corporation, and Y, the controlled corporation, is a QOF immediately after the Distribution, the Distribution is a qualifying section 355 transaction. Thus, the Distribution is not an inclusion event for purposes of section 1400Z–2(b)(1) and paragraph (b) of this section. See paragraph (c)(11)(i)(B) of this section. Accordingly, A is not required to include in income in 2025 any of its $500 of deferred capital gain as a result of the Distribution. For purposes of section 1400Z–2(b)(2)(B) and (c), A's holding period for its qualifying investment in Y is treated as beginning on October 31, 2019. See paragraph (d)(1)(ii) of this section.

(iii) *Section 355 distribution by a QOF shareholder*. The facts are the same as in paragraph (f)(8)(i) of this section (this *Example 8*), except that A distributes 80 percent of the stock of Q, all of which is a qualifying investment in the hands of A, to A's shareholders in a transaction in which no gain or loss is recognized under section 355. At the time of the distribution, the fair market value of A's Q stock exceeds $500. The distribution is an inclusion event for purposes of section 1400Z–2(b)(1) and paragraph (b) of this section, and A is required to include in income $400 (80 percent of its $500 of deferred capital gain) as a result of the distribution. See paragraphs (c)(1) and (c)(11)(ii) of this section.

(iv) *Distribution of boot*. The facts are the same as in paragraph (f)(8)(i) of this section (this *Example 8*), except that A receives boot in the Distribution. Under paragraphs (c)(8)(i) and (c)(11)(i)(B)(*3*) of this section, the receipt of boot in the Distribution is an inclusion event for purposes of section 1400Z–2(b)(1) and paragraph (b) of this section to the extent of gain recognized pursuant to section 301(c)(3).

(v) *Section 355 split-off*. The facts are the same as in paragraph (f)(8)(i) of this section (this *Example 8*), except that Q stock is directly owned by both A and B (each of which has made a qualifying investment in Q), and Q distributes all of the Y stock to B in exchange for B's Q stock in a transaction in which no gain or loss is recognized under section 355. The distribution is a qualifying section 355 transaction and is not an inclusion event for purposes of section 1400Z–2(b)(1) and paragraph (b) of this section. Neither A nor B is required to include its deferred capital gain in income in 2025 as a result of the distribution.

(vi) *Section 355 split-up*. The facts are the same as in paragraph (f)(8)(v) of this section (this *Example 8*), except that Q wholly and directly owns both Y and Z; Q distributes all of the Y stock to A in exchange for A's Q stock and distributes all of the Z stock to B in exchange for B's Q stock in a transaction in which no gain or loss is recognized under section 355; Q then liquidates; and immediately after the Distribution, each of Y and Z satisfies the requirements for QOF status. The

distribution is a qualifying section 355 transaction and is not an inclusion event for purposes of section 1400Z–2(b)(1) and paragraph (b) of this section. Neither A nor B is required to include its deferred capital gain in income in 2025 as a result of the transaction.

(vii) *Section 355 split-off with boot*. The facts are the same as in paragraph (f)(8)(v) of this section (this *Example 8*), except that B also receives boot. Under paragraph (c)(11)(i)(B)(*3*) of this section, B has an inclusion event and is treated as disposing of a portion of its qualifying investment that bears the same proportion to B's total qualifying investment immediately before the inclusion event as the fair market value of the boot bears to the fair market value of the total consideration received by B.

(9) *Example 9. Recapitalization*—(i) *Facts*. On May 31, 2019, each of A and B sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A contributes $500 to newly formed Q in exchange for 50 shares of class A stock of Q (A's qualifying investment) and B contributes $500 to Q in exchange for 60 shares of class B stock of Q (B's qualifying investment). A and B are the sole shareholders of Q. In 2020, B exchanges all of its class B stock of Q for 40 shares of class A stock of Q as well as other property in a transaction that qualifies as a reorganization under section 368(a)(1)(E).

(ii) *Analysis*. Because A did not receive any boot in the transaction, A does not have an inclusion event with respect to its qualifying investment in Q. See paragraph (c)(12)(i) of this section. Therefore, A is not required to include any of its deferred gain in income as a result of this transaction. However, under paragraph (c)(12)(ii) of this section, B has an inclusion event. If section 301 applies to the boot received by B, B has an inclusion event to the extent of its section 301(c)(3) gain. If section 356(a) or (c) applies to the boot received by B, B is treated as disposing of a portion of its qualifying investment that bears the same proportion to B's total qualifying investment immediately before the inclusion event as the fair market value of the boot bears to the fair market value of the total consideration received by B.

(10) *Example 10. Debt financed distribution*—(i) *Facts*. On September 24, 2019, A and B form Q, a QOF partnership, each contributing $200 that is deferred under the section 1400Z–2(a) election to Q in exchange for a qualifying investment. On November 18, 2022, Q obtains a nonrecourse loan from a bank for $300. Under section 752, the loan is allocated $150 to A and $150 to B. On November 30, 2022, when the values and bases of the investments remain unchanged, Q distributes $50 to A.

(ii) *Analysis*. A is not required to recognize gain under paragraph (c) of this section because A's basis in its qualifying investment is $150 (the original zero basis with respect to the contribution, plus the $150 debt allocation). The distribution reduces A's basis to $100.

(11) *Example 11. Debt financed distribution in excess of basis*—(i) *Facts*. The facts are the same as in paragraph (f)(10) of this section (*Example 10*), except that the loan is entirely allocated to B under section 752. On November 30, 2024, when the values of the investments remain unchanged, Q distributes $50 to A.

(ii) *Analysis*. Under paragraph (c)(6)(iii) of this section, A is required to recognize $30 of eligible gain under paragraph (c) of this section because the $50 distributed to A exceeds A's $20 basis in its qualifying investment (the original zero basis with respect to its contribution, plus $20 with regard to section 1400Z–2(b)(2)(B)(iii)).

(g) *Basis adjustments*—(1) *Basis adjustments under section 1400Z–2(b)(2)(B)(ii) resulting from the inclusion of deferred gain*—(i) *In general*. Except as provided in paragraph (g)(1)(ii) of this section, basis adjustments under section 1400Z–2(b)(2)(B)(ii) are made immediately after the amount of gain determined under section 1400Z–2(b)(2)(A) is included in income under section 1400Z–2(b)(1). If the basis adjustment under section 1400Z–2(b)(2)(B)(ii) is being made as a result of an inclusion event, then the basis adjustment is made before determining the other Federal income tax consequences of the inclusion event.

(ii) *Specific application to section 301(c)(3) gain, section 1059(a)(2) gain, S corporation shareholder gain, or partner gain*—(A) *Applicability*. This paragraph (g)(1)(ii) applies if a QOF makes a distribution to its owner, and if, without regard to any basis adjustment under section 1400Z–2(b)(2)(B)(ii), at least a portion of the distribution would be characterized as gain under section 301(c)(3), section 1059(a)(2), or paragraphs (c)(6)(iii) and (c)(7)(ii) of this section with respect to the owner's qualifying investment in the QOF.

(B) *Ordering rule*. If paragraph (g)(1)(ii) of this section applies, an eligible taxpayer is treated as having an inclusion event to the extent provided in paragraph (c)(6)(iii), (c)(7)(ii), or (c)(8), (9), (11), (12), or (13) of this section, as applicable. Then, the eligible taxpayer increases its basis under section 1400Z–2(b)(2)(B)(ii) before determining the Federal income tax consequences of the distribution.

(iii) *Shares in QOF C corporations to which section 1400Z–2(b)(2)(B)(ii) adjustments are made.* If a shareholder of a QOF C corporation disposes of qualifying QOF stock in an exchange subject to section 1001, basis adjustments under section 1400Z–2(b)(2)(B)(ii) are made only to the portion of the qualifying investment that is disposed of in the inclusion event.

(2) *Amount of basis adjustment under section 1400Z–2(b)(2)(B)(iii) and (iv).* The increases in basis under section 1400Z–2(b)(2)(B)(iii) and (iv) are limited to 10 percent and 5 percent, respectively, of the remaining deferred gain with respect to a qualifying investment as of the dates on which basis is increased under that section.

(3) *Examples.* The following examples illustrate the rules of paragraphs (g)(1) and (2) of this section.

(i) *Example 1*—(A) *Facts.* On May 31, 2019, A, a C corporation, sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A contributes $500 to Q, a newly formed QOF C corporation, in exchange for all of the outstanding Q common stock and elects to defer the recognition of $500 of capital gain under section 1400Z–2(a) and §1.1400Z2(a)–1. In 2020, when Q has $40 of earnings and profits, Q distributes $100 to A (Distribution).

(B) *Recognition of gain.* Under paragraph (g)(1)(ii)(B) of this section, the Distribution is first evaluated without regard to any basis adjustment under section 1400Z–2(b)(2)(B)(ii). Of the $100 distribution, $40 is treated as a dividend and $60 is treated as gain from the sale or exchange of property under section 301(c)(3), because A's basis in its Q stock is $0 under section 1400Z–2(b)(2)(B)(i). Under paragraphs (c)(8)(i) and (e)(2) of this section, $60 of A's gain that was deferred under section 1400Z–2(a) and §1.1400Z2(a)–1 is recognized in 2020. Pursuant to §1.312–6(b), A's earnings and profits increase by $60.

(C) *Basis adjustments.* Under paragraph (g)(1)(ii)(B) of this section, prior to determining the further tax consequences of the Distribution, A increases its basis in its Q stock by $60 in accordance with section 1400Z–2(b)(2)(B)(ii). As a result, the Distribution is characterized as a dividend of $40 under section 301(c)(1) and a return of basis of $60 under section 301(c)(2). Therefore, after the section 301 distribution, A's basis in Q is $0 ($60 − $60).

(ii) *Example 2*—(A) *Facts.* The facts are the same as in paragraph (g)(3)(i) of this section (*Example 1*), except that, instead of receiving a distribution, A sells half of the Q stock for $250 in 2020. A continues to hold the remainder of its Q stock through 2024.

(B) *Recognition of gain and basis adjustments in 2020.* Under paragraphs (c)(1) and (e)(1) of this section, $250 of A's gain that was deferred under section 1400Z–2(a) and §1.1400Z2(a)–1 is recognized in 2020. Under paragraphs (g)(1)(i) and (iii) of this section, A increases its basis to $250 in the sold shares in accordance with section 1400Z–2(b)(2)(B)(ii) immediately before the sale. Accordingly, A has no gain or loss on the sale ($250 − $250). Pursuant to §1.312–6(b), A's earnings and profits increase by $250. A's basis in its remaining shares of Q stock remains $0.

(C) *Basis adjustment in 2024.* Under paragraph (g)(2) of this section, A increases its basis in its remaining shares of Q stock in accordance with section 1400Z–2(b)(2)(B)(iii). Pursuant to §1.312–6(b), A's earnings and profits are increased by the amount of the basis adjustment.

(4) *Special partnership rules*—(i) *General rule.* The initial basis under section 1400Z–2(b)(2)(B)(i) of a qualifying investment in a QOF partnership is zero, as adjusted to take into account the contributing partner's share of partnership debt under section 752.

(ii) *Treatment of basis adjustments.* Any basis adjustment to a qualifying investment in a QOF partnership described in section 1400Z–2(b)(2)(B)(iii) and (iv) and section 1400Z–2(c) is basis for all purposes, including for purposes of suspended losses under section 704(d).

(iii) *Tiered arrangements.* Any basis adjustment described in section 1400Z–2(b)(2)(B)(iii) and (iv) and section 1400Z–2(c) (basis adjustment rules) will be treated as an item of income described in section 705(a)(1) and must be reported in accordance with the applicable forms and instructions. Any amount to which the basis adjustment rules or to which section 1400Z–2(b)(1) applies will be allocated to the owners of the QOF, and to the owners of any partnership that directly or indirectly (solely through one or more partnerships) owns the eligible interest, and will track to the owners' interests, based on their shares of the remaining deferred gain to which such amounts relate.

(5) *Basis adjustments in S corporation stock*—(i) *Treatment of basis adjustments.* Any basis adjustment to a qualifying investment in a QOF S corporation described in section 1400Z–2(b)(2)(B)(iii)

and (iv) and section 1400Z–2(c) is basis for all purposes, including for purposes of suspended losses under section 1366(d).

(ii) *S corporation investor in QOF*—(A) *S corporation*. If an S corporation is an investor in a QOF, the S corporation must adjust the basis of its qualifying investment as set forth in this paragraph (g). The rule in this paragraph (g)(5)(ii)(A) does not affect adjustments to the basis of any other asset of the S corporation.

(B) *S corporation shareholder*—(*1*) *In general*. The S corporation shareholder's pro-rata share of any recognized capital gain that has been deferred at the S corporation level will be separately stated under section 1366 when recognized and will adjust the shareholders' stock bases under section 1367 at that time.

(*2*) *Basis adjustments to qualifying investments*. Any adjustment made to the basis of an S corporation's qualifying investment under section 1400Z–2(b)(2)(B)(iii) or (iv), or section 1400Z–2(c), will not:

(*i*) Be separately stated under section 1366; or

(*ii*) Until the date on which an inclusion event with respect to the S corporation's qualifying investment occurs, adjust the shareholders' stock bases under section 1367.

(*3*) *Basis adjustments resulting from inclusion events*. If the basis adjustment under section 1400Z–2(b)(2)(B)(ii) is being made as a result of an inclusion event, then the basis adjustment is made before determining the tax consequences of the inclusion event other than the computation of the tax on the deferred gain.

(iii) *QOF S corporation*—(A) *Transferred basis of assets received*. If a QOF S corporation receives an asset in exchange for a qualifying investment, the basis of the asset shall be the same as it would be in the hands of the transferor, increased by the amount of the gain recognized by the transferor on such transfer.

(B) *Basis adjustments resulting from inclusion events*. If the basis adjustment under section 1400Z–2(b)(2)(B)(ii) for the shareholder of the QOF S corporation is being made as a result of an inclusion event, then the basis adjustment is made before determining the tax consequences of the inclusion event other than the computation of the tax on the deferred gain.

(6) *Basis in the hands of a taxpayer who received a qualifying investment in a QOF by reason of the prior owner's death*—(i) *In general*. The basis of a qualifying investment in a QOF, transferred by reason of a decedent's death in a transfer that is not an inclusion event, is zero under section 1400Z–2(b)(2)(B)(i), as adjusted for increases in basis as provided under section 1400Z–2(b)(2)(B)(ii) through (iv) and (c). See paragraph (c)(4) of this section.

(ii) *Examples*. The following examples illustrate the rule of this paragraph (g)(6).

(A) *Example 1*. Taxpayer A, an individual, contributed $50X to a QOF in exchange for a qualifying investment in the QOF in January 2019. This $50X was capital gain that was excluded from A's gross income under section 1400Z–2(a)(1)(A). A's basis in the qualifying investment is zero. As of January 2024, A's basis in the QOF is increased by an amount equal to 10 percent of the amount of gain deferred by reason of section 1400Z–2(a)(1)(A), so that A's adjusted basis in 2024 is $5X. A dies in 2025 and A's heir inherits this qualifying investment in the QOF. A's death is not an inclusion event for purposes of section 1400Z–2. The heir's basis in the qualifying investment is $5X.

(B) *Example 2*. The facts are the same as in paragraph (g)(6)(ii)(A) of this section (*Example 1*), except that A dies in November 2027, when the fair market value of the qualifying investment was $75X. A was required to pay the tax on the excess of the deferred capital gain over A's basis as part of A's 2026 income. Therefore, at the time of A's death, A's basis in the qualifying investment is the sum of three basis adjustments: The adjustment made in January 2024 described in paragraph (g)(6)(ii)(A) (*Example 1*) ($5X); an additional adjustment made as of January 2026 equal to 5 percent of the amount of gain deferred by reason of section 1400Z–2(a)(1)(A) ($2.5X); and the adjustment as of December 31, 2026, by reason of section 1400Z–2(b)(1)(B) and (b)(2)(B)(ii) ($42.5X). Accordingly, the basis of the qualifying investment in the hands of A's heir is $50X.

(h) *Notifications by partners and partnerships, and shareholders and S corporations*—(1) *Notification of deferral election*. A partnership that makes a deferral election must notify all of its partners of the deferral election and state each

partner's distributive share of the deferred gain in accordance with applicable forms and instructions.

(2) *Notification of deferred gain recognition by indirect QOF owner*. If an indirect owner of a QOF partnership sells or otherwise disposes of all or a portion of its indirect interest in the QOF partnership in a transaction that is an inclusion event under paragraph (c) of this section, such indirect owner must provide to the QOF owner notification and information sufficient to enable the QOF owner, in a timely manner, to recognize an appropriate amount of deferred gain.

(3) *Notification of section 1400Z–2(c) election*. A QOF partner or QOF S corporation shareholder must notify the QOF partnership or QOF S corporation, as appropriate, of an election under section 1400Z–2(c) to adjust the basis of the qualifying QOF partnership interest or qualifying QOF stock, as appropriate, that is disposed of in a taxable transaction. Notification of the section 1400Z–2(c) election, and the adjustments to the basis of the qualifying QOF partnership interest(s) or qualifying QOF stock disposed of, or to the QOF partnership asset(s) or QOF S corporation asset(s) disposed of, as appropriate, is to be made in accordance with applicable forms and instructions.

(i) [Reserved]

(j) *Applicability dates*—(1) *In general*. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2) *Prior periods*. With respect to the portion of a taxpayer's first taxable year ending after December 21, 2017, that began on December 22, 2017, and for taxable years beginning after December 21, 2017, and on or before March 13, 2020, a taxpayer may choose either—

(i) To apply section 1400Z–2 regulations, if applied in a consistent manner for all such taxable years; or

(ii) To rely on the rules in proposed §1.1400Z2(b)–1 contained in the notice of proposed rulemaking (REG–120186–18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

[T.D. 9889, 85 FR 1964, Jan. 13, 2020; 85 FR 19083, Apr. 6, 2020]

EDITORIAL NOTE: At 85 FR 19083, April 6, 2020, §1.1400Z2(b)–1 was amended in part by revising paragraphs (j)(2) introductory text and (j)(2)(i); however, the amendment could not be incorporated due to inaccurate amendatory instruction.

§1.1400Z2(c)–1 Investments held for at least 10 years.

(a) *Scope*. This section provides rules under section 1400Z–2(c) of the Internal Revenue Code regarding the election to adjust the basis in a qualifying investment in a QOF or in certain eligible property held by the QOF. See §1.1400Z2(b)–1(d) for rules for determining the holding period of a qualifying investment for purposes of this section.

(b) *Investment for which an election can be made*—(1) *In general*—(i) *Election by taxpayer*. An eligible taxpayer who makes a deferral election with respect to, or acquires by reason of a transaction that is not an inclusion event, a qualifying investment in a QOF, recognizes gain (if any) on December 31, 2026, of an amount determined under §1.1400Z2(b)–1(e)(3) (and so much of §1.1400Z2(b)–1(e)(4) as relates to §1.1400Z2(b)–1(e)(3)) with respect to that qualifying investment, and whose holding period in that qualifying investment is at least ten years, is eligible to make an election described in section 1400Z–2(c) on the sale or exchange of that qualifying investment. Except as otherwise provided in this paragraph (b)(1), to the extent a taxpayer described in the preceding sentence has an inclusion event described in §1.1400Z2(b)–1(c) with respect to any portion of a qualifying investment, that portion is no longer a qualifying investment and the taxpayer is not eligible to make an election pursuant to section 1400Z–2(c) and this section with respect to that portion. See §1.1400Z2(c)–1(b)(2) for special election rules for QOF partnerships and QOF S corporations.

(ii) *Transferee partnership to make an election under section 1400Z–2(c)*—(A) *In general*. This paragraph (b)(1)(ii)(A) applies if an eligible taxpayer (transferor) transfers its qualifying investment to a transferee in a transaction described in §1.1400Z2(b)–1(c)(6)(ii) to the extent governed by section 721(a). If this paragraph (b)(1)(ii)(A) applies, and if the

transferee sells or exchanges a qualifying investment that has a holding period of at least 10 years under §1.1400Z2(b)–1(d)(1)(ii)(F), then the transferee can make an election described in section 1400Z–2(c) on the sale or exchange of the qualifying investment. See §1.1400Z2(b)–1(c)(6)(ii)(B) (transferee partnership makes section 1400Z–2(c) election regarding contributed qualifying investment).

(B) *Conditions for transferee partnership or merged partnership to make an election described in section 1400Z–2(c).* A transferee referred to in paragraph (b)(1)(ii)(A) of this section is eligible to make an election described in section 1400Z–2(c) with respect to a qualifying investment only if the transferee:

(*1*) Files a statement, at the time and in the manner that the Commissioner of Internal Revenue may prescribe by Internal Revenue Service forms and instructions or by publication in the Internal Revenue Bulletin (see §601.601(d)(ii)(b) of this chapter), providing the name of the transferor, the date of the transfer, and the transferor's holding period in the transferred qualifying investment immediately before the transfer; and

(*2*) Files form 8997, *Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments*, with the transferee's timely filed Federal Tax Return.

(iii) *Limitation on the 10-year rule.* As required by section 1400Z–2(e)(1) (treatment of investments with mixed funds), section 1400Z–2(c) applies only to the portion of an investment in a QOF that is a qualifying investment. For rules governing the application of section 1400Z–2(c) to the portion of an investment in a QOF for which a loss has been claimed under section 165(g) or otherwise, see §1.1400Z2(b)–1(c)(14).

(iv) *Transactions to which section 301(c)(3), section 1059(a)(2), or section 1368(b)(2) or (c)(3) applies.* The receipt of amounts treated as gain from the sale or exchange of property under section 301(c)(3), section 1059(a)(2), or section 1368(b)(2) or (c)(3) with respect to qualifying QOF stock in a transaction treated as an inclusion event under §1.1400Z2(b)–1(c) does not prevent the QOF shareholder from making a subsequent election described in section 1400Z–2(c) with respect to that qualifying QOF stock.

(v) *Partnership distributions in excess of basis.* The occurrence of an inclusion event described in §1.1400Z2(b)–1(c)(6)(iii), which addresses a distribution of property by a QOF partnership to a QOF partner where the distributed property has a fair market value in excess of the QOF partner's basis in its qualifying investment, does not prevent the QOF partner from making a subsequent election described in section 1400Z–2(c) with respect to the QOF partner's qualifying QOF partnership interest.

(2) *Special election rules for QOF partnerships and QOF S corporations*—(i) *Dispositions of qualifying QOF partnership interests.* If a QOF partner's basis in a qualifying QOF partnership interest is adjusted under section 1400Z–2(c) upon the disposition of a qualifying investment, then the basis of the QOF partnership interest is adjusted to an amount equal to the net fair market value of the interest, plus the QOF partner's share of QOF partnership indebtedness under section 752 with respect to that interest, and immediately prior to the sale or exchange, the bases of the assets of the QOF partnership and of any partnership owned directly or indirectly by the QOF partnership solely through one or more partnerships are also adjusted with respect to the disposed-of qualifying investment. For purposes of this paragraph (b)(2)(i), section 7701(g) will apply in determining the value of a qualifying investment in a QOF partnership. The adjustments in this paragraph (b)(2)(i) are calculated in a manner similar to the section 743(b) adjustments that would have been made if the transferor QOF partner had purchased its interest in the QOF partnership for cash equal to the fair market value of the interest immediately prior to the sale or exchange, assuming that valid section 754 elections had been in place with respect to the QOF partnership and any partnerships directly or indirectly owned by the QOF partnership, whether or not an actual section 754 election is in place for any of the partnerships. This paragraph (b)(2)(i) applies without regard to the amount of deferred gain

that was included under section 1400Z–2(b)(1) or the timing of that inclusion.

(ii) *Sales or exchanges of QOF property by QOF partnerships or QOF S corporations*—(A) *Election to exclude gains and losses*. If a taxpayer has held a qualifying investment in a QOF partnership or QOF S corporation for at least 10 years, as determined under §1.1400Z2(b)–1(d), and the QOF partnership or QOF S corporation or any partnership that is owned directly, or indirectly solely through one or more partnerships, by the QOF partnership or QOF S corporation sells or exchanges property, the taxpayer may make an election under this paragraph (b)(2)(ii)(A) to exclude from the taxpayer's income all gains and losses allocable to the qualifying investment that arise from all such sales or exchanges for the QOF partnership's or QOF S corporation's taxable year. In order for the election to be valid, the requirements set forth in paragraph (b)(2)(ii)(B) of this section must be satisfied. For purposes of paragraph (b)(2)(ii) of this section, gains and losses include all gains and losses other than gains or losses from the sale or exchange of any item of inventory, as defined in section 1221(a)(1), in the ordinary course of business.

(B) *Deemed distribution and recontribution*—(*1*) *In general*. If any partner of a QOF partnership, or shareholder of a QOF S corporation, makes an election under paragraph (b)(2)(ii)(A) of this section, the taxpayer is treated as receiving a distribution of cash as calculated under paragraph (b)(2)(ii)(B)(*2*) of this section, from the QOF partnership or QOF S corporation at the end of the QOF partnership's or QOF S corporation's taxable year and immediately recontributing the cash to the QOF partnership or QOF S corporation in exchange for a non-qualifying investment in the QOF partnership or QOF S corporation. In determining the post-contribution qualifying investment and non-qualifying investment, the QOF will value each interest based on the underlying values of the QOF's assets determined at the end of its taxable year in accordance with the principles of §1.704–1(b)(2)(iv) (in the case of a QOF partnership) or fair market value (in the case of a QOF S corporation). If the QOF partner or QOF S corporation shareholder is a mixed-funds partner or shareholder prior to the sale or exchange, the deemed distribution will be treated as made proportionately with respect to the partner's or shareholder's qualifying investment and non-qualifying investment in the QOF partnership in accordance with §1.1400Z2(b)–1(c)(6)(iv)(B), or the QOF S corporation. The distribution and recontribution rule of paragraph (b)(2)(ii)(B) of this section is solely for purposes of determining the taxpayer's interests in the QOF partnership or QOF S corporation that constitute a qualifying investment and a non-qualifying investment, and has no other Federal income tax consequence (for example, the rule does not affect the accumulated adjustments account of an S corporation and cannot be treated as a disproportionate distribution by an S corporation).

(*2*) *Amount of deemed distribution and re-contribution*. The amount of cash referred to in paragraph (b)(2)(ii)(B)(*1*) of this section that is deemed distributed by and recontributed to the QOF partnership or QOF S corporation is equal to—

(*i*) The partner's or shareholder's share of net proceeds from all sales and exchanges of property described in paragraph (b)(2)(ii)(A) of this section (other than sales of inventory in the ordinary course of business) for the taxable year for which the election under paragraph (b)(2)(ii)(A) is made (calculated without regard to whether any gain or loss is recognized with regard to such property); less

(*ii*) All actual distributions of cash by the QOF partnership or QOF S corporation with respect to any such sale or exchange that is made within 90 days of the sale or exchange.

(*3*) *Meaning of net proceeds*—(*i*) *QOF partnerships*. For purposes of paragraph (b)(2)(ii)(B)(*2*)(*i*) of this section, with respect to QOF partnerships, the term ''net proceeds'' means the amount realized from the sale of property described in paragraph (b)(2)(ii)(A) of this section less any indebtedness included in the amount realized that would constitute a qualified liability under §1.707–5(a)(6) if the sold or exchanged property had

been contributed to a lower-tier partnership subject to the debt.

(*ii*) *QOF S corporations*. For purposes of paragraph (b)(2)(ii)(B)(*2*)(*i*) of this section, with respect to QOF S corporations, the term ''net proceeds'' means the amount realized from the sale of property described in paragraph (b)(2)(ii)(A) of this section less any indebtedness included in the amount realized that would constitute a qualified liability under the principles of §1.707–5(a)(6).

(C) *Treatment as exempt income*—(*1*) *General rule*. With respect to the taxpayer making an election under paragraph (b)(2)(ii) of this section, the excess of any gains over losses excluded from income under paragraph (b)(2)(ii) of this section is treated as income of the partnership or S corporation that is exempt from tax under the Internal Revenue Code for purposes of section 705(a)(1)(B) or section 1367(a)(1)(A). Section 265 or any similar provisions do not apply to disallow any deductions otherwise allowable under subtitle A for amounts paid or incurred by a taxpayer that are allocable to any gain excluded from income under paragraph (b)(2)(ii) of this section.

(*2*) *Special rule regarding accumulated adjustments account*. Solely for purposes of determining whether an adjustment must be made to the accumulated adjustments account of an S corporation, the excess amount described in paragraph (b)(2)(ii)(C)(*1*) of this section is not treated as tax exempt income.

(D) *Time and manner of making the election to exclude gain*. An election under paragraph (b)(2)(ii)(A) of this section is made by filing the applicable form with the taxpayer's timely filed income tax return, without extensions, for its taxable year that includes the taxable year end of the QOF partnership or QOF S corporation. A taxpayer must make the election under paragraph (b)(2)(ii)(A) of this section for each taxable year in which it wishes to exclude gains and losses of a QOF partnership or QOF S corporation.

(3) *Basis adjustments upon sale or exchange of qualifying QOF stock*—(i) *In general*. Except as provided in paragraph (b)(3)(ii) of this section, if a QOF shareholder's basis in qualifying QOF stock is adjusted under section 1400Z–2(c), then the basis of the qualifying QOF stock is adjusted to an amount equal to the fair market value of the qualifying QOF stock immediately prior to the sale or exchange. This paragraph (b)(3)(i) applies without regard to the amount of deferred gain that was included under section 1400Z–2(b)(1) or the timing of that inclusion.

(ii) *Specific application to transactions to which section 301(c)(3), section 1059(a)(2), or section 1368(b)(2) or (c)(3) applies*—(A) *Applicability*. This paragraph (b)(3)(ii) applies if a QOF corporation makes a distribution to a QOF shareholder, at least a portion of the distribution would be characterized as gain from a sale or exchange under section 301(c)(3), section 1059(a)(2), or section 1368(b)(2) or (c)(3) with respect to the QOF shareholder's qualifying QOF stock without regard to any basis adjustment under section 1400Z–2(c), and the QOF shareholder elects to adjust the basis of its qualifying QOF stock under section 1400Z–2(c).

(B) *Ordering rule*. If paragraph (b)(3)(ii) of this section applies with respect to a QOF corporation, the QOF shareholder increases its basis by the lesser of the amount of the distribution characterized as gain from a sale or exchange or the fair market value of the QOF shareholder's qualifying QOF stock before determining the Federal income tax consequences of the distribution.

(c) *Extension of availability of the election described in section 1400Z–2(c)*. The ability to make an election under section 1400Z–2(c) for investments held for at least 10 years is not impaired solely because, under section 1400Z–1(f), the designation of one or more qualified opportunity zones ceases to be in effect. The preceding sentence does not apply to elections under section 1400Z–2(c) that are related to dispositions occurring after December 31, 2047.

(d) *Examples*. The following examples illustrate the principles of paragraphs (a) through (c) of this section.

(1) *Example 1*—(i) *Facts*. In 2020, taxpayer A invests $100 in QOF S, a QOF S corporation, in exchange for a qualifying investment and defers $100 of gain. At the end of 2028, the qualified opportunity zone designation expires for the population census tract in which QOF S primarily conducts its trade or business. In 2031, A sells all of its QOF S

shares, realizes gain, and makes an election to increase the qualifying basis in its QOF S shares to fair market value. But for the expiration of the designated zones in section 1400Z–1(f), QOF S and A's conduct is consistent with continued eligibility to make the election under section 1400Z–2(c).

(ii) *Analysis.* Under paragraph (c) of this section, although the designation expired on December 31, 2028, the expiration of the zone's designation does not, without more, invalidate A's ability to make an election under section 1400Z–2(c). Accordingly, pursuant to that election, A's basis in the QOF stock is increased to its fair market value and A recognizes no gain or loss on the sale.

(2) *Example 2*—(i) *Facts.* In 2019, taxpayer A realizes $100 of eligible gain and contributes $100 to a QOF partnership, X, in exchange for a qualifying QOF partnership interest in X, and taxpayer B contributes $100 of eligible gain to another QOF partnership, Y, in exchange for a qualifying QOF partnership interest in Y. In 2021, in transactions governed by section 721(a), A contributes her qualifying QOF partnership interest in X, and B contributes her qualifying QOF partnership interest in Y, to a newly formed partnership, UTP. In 2024, C receives a profits interest in UTP for services that she will provide to UTP. In 2031, X sells a non-inventory asset and allocates X's distributive share of the gain to UTP. No distributions are ever made from X, Y, or UTP.

(ii) *Analysis.* On December 31, 2026, UTP recognizes $170 of remaining deferred gain relating to the QOF interests. Of that gain, A is allocated the $85 of gain relating to the $100 of eligible gain that she invested in X, and B is allocated the $85 of gain relating to the $100 of eligible gain that she invested in Y. C recognizes no gain at this time. In 2031, because UTP's holding period in X includes A's holding period in X, UTP has a holding period in X that exceeds 10 years, and may make an election under §1.1400Z2(c)–1(b)(2)(ii)(A) to exclude the gain from X's asset sale. Even though A was the original investor in X, she may not make the election. If UTP makes the election, UTP will exclude its distributive share of gain from the sale of the X asset.

(3) *Example 3*—(i) *Facts.* In 2019, taxpayer B invests $100 in P, a QOF partnership, in exchange for a qualifying investment and properly makes an election under section 1400Z–2(a) to defer $100 of eligible gain. B's interest in the partnership is 50 percent. In 2030, when B's interest in P has a value of $130 and a basis of $100, B sells the interest, recognizing $30 of gain, $15 of which is attributable to inventory assets of P. B makes an election under section 1400Z–2(c) with respect to the sale.

(ii) *Analysis.* Because B's election under section 1400Z–2(c) is in effect with respect to the sale, the bases of B's interest in P and of P's assets with respect to the interest sold are adjusted to fair market value immediately before B's sale under paragraph (b)(2)(i) of this section, and B recognizes no gain or loss on the sale.

(4) *Example 4*—(i) *Facts.* The facts are the same as in paragraph (d)(3) of this section (*Example 3*), except that P sells qualified opportunity zone property that is not inventory sold in the ordinary course of business and distributes all of the proceeds from the sale to partners within 90 days of the sale (the qualified opportunity zone property was the only property sold by P in the taxable year). The sold property has a value of $60 and a basis of $40. P recognizes $20 of gain, $10 of which is allocable to B, and B makes an election under paragraph (b)(2)(ii)(A) of this section for the year in which B's allocable share of the partnership's recognized gain would be included in B's gross income.

(ii) *Analysis.* Because B's election under paragraph (b)(2)(ii)(A) of this section is in effect, B will exclude its entire $10 allocable share of the partnership's $20 of recognized gain. Because $10 of the sale proceeds were actually distributed to B within 90 days of the sale, P is not treated as making a deemed distribution and receiving a recontribution under paragraph (b)(2)(ii)(B) of this section with respect to B.

(5) *Example 5*—(i) *Facts.* In 2019, taxpayer C invests $100 in Q, a QOF partnership, in exchange for a qualifying investment and properly makes an election under section 1400Z–2(a) to defer $100 of eligible gain. C's interest in Q is 50%. Q's taxable year ends on December 31. In 2025, Q purchases three qualified opportunity zone properties, X, Y, and Z. On January 22, 2031, Q sells property X for $200, recognizing $140 of gain. On July 31, 2031, Q sells property Y for $80, recognizing $20 of loss. Q makes no distributions to its partners in 2031, has no indebtedness, and has no other gain or loss other than from the sales of properties X and Y. Property Z has a value of $280 at all times throughout 2031. C's share of Q's gain and loss is $70 and $10, respectively, for a net gain of $60, and C makes an election under paragraph (b)(2)(ii)(A) of this section to exclude the gains and losses from its income.

(ii) *Analysis.* Because C has made an election under paragraph (b)(2)(ii)(A) of this section, under paragraph (b)(2)(ii)(B) of this section, C is treated as receiving a cash distribution of $140 from Q, C's share of the net proceeds from the sales of properties X and Y, on December 31, 2031, and immediately recontributing $140 to Q in exchange for a non-qualifying investment in Q. Beginning on January 1, 2032, 50 percent of A's interest in Q is a qualifying investment, and 50 percent of A's investment in Q is a non-qualifying investment. This amount is calculated as a fraction, the numerator of which is $140, the

amount deemed distributed and recontributed, and the denominator of which is $280, the value of C's interest prior to the deemed distribution.

(6) *Example 6*—(i) *Facts*. The facts are the same as in paragraph (d)(5) of this section (*Example 5*), except that Q distributes all of the proceeds from the sale of property X to its partners on March 30, 2031. Q does not make any distribution of proceeds from the sale of property Y.

(ii) *Analysis*. Under paragraph (b)(2)(iii)(B)(*2*)(*ii*) of this section, the actual distribution of cash to C on March 30, 2031, reduces the amount of the deemed distribution and recontribution with respect to C on December 31, 2031. Accordingly, the amount of C's deemed distribution and recontribution is $40, which increases C's non-qualifying investment to 22 percent. This amount is calculated as a fraction, the numerator of which is $40, the amount deemed distributed and recontributed, and the denominator of which is $180, the value of C's interest.

(7) *Example 7. Section 301(c)(3) gain*—(i) *Facts*. In 2020, taxpayer X makes an investment in Q, a QOF corporation, in exchange for a qualifying investment. In 2031, when X's qualifying Q stock is worth $1000x, Q makes a distribution to X with respect to X's qualifying QOF stock, $500x of which is treated as gain from a sale or exchange under section 301(c)(3). In 2032, X disposes of all of its qualifying QOF stock in Q.

(ii) *Analysis*—(A) *Section 301(c)(3) distribution*. X is eligible to make an election described in section 1400Z–2(c) in 2031 with respect to its $500x gain. Under paragraph (b)(3)(ii) of this section, the basis adjustment is $500x, the lesser of $500x, the amount of the distribution treated as gain from the sale or exchange of property, and $1000x, the fair market value of the qualifying QOF stock before the distribution. As a result of the election, X increases its basis in its qualifying QOF stock in Q by $500x immediately before the distribution; consequently, the $500x is treated as a return of basis under section 301(c)(2).

(B) *Disposition of qualifying QOF stock*. X is eligible to make an election described in section 1400Z–2(c) in 2032 with respect to all of its qualifying QOF stock in Q, notwithstanding X's receipt of a section 301(c)(3) distribution in 2031. See paragraph (b)(1)(iv) of this section.

(e) *Capital gain dividends paid by a QOF RIC or QOF REIT that some shareholders may be able to elect to receive tax free under section 1400Z–2(c)*—(1) *Eligibility*. For purposes of paragraph (b) of this section, if a shareholder of a QOF RIC or QOF REIT receives a capital gain dividend identified with a date, as defined in paragraph (e)(2) of this section, then, to the extent that the shareholder's shares in the QOF RIC or QOF REIT paying the capital gain dividend are a qualifying investment in the QOF RIC or QOF REIT—

(i) The shareholder may treat the capital gain dividend, or part thereof, as gain from the sale or exchange of a qualifying investment on the date that the QOF RIC or QOF REIT identified with the dividend; and

(ii) If, on the date identified, the shareholder had held that qualifying investment in the QOF RIC or QOF REIT for at least 10 years, then the shareholder may exclude that capital gain dividend, or part thereof, from its taxable income for the taxable year.

(2) *Definition of capital gain dividend identified with a date*. A *capital gain dividend identified with a date* means an amount of a capital gain dividend, as defined in section 852(b)(3)(C) or 857(b)(3)(B), or part thereof, and a date that the QOF RIC reports or QOF REIT designates in a notice provided to the shareholder not later than one week after the QOF RIC reports or QOF REIT designates the capital gain dividend pursuant to section 852(b)(3)(C) or 857(b)(3)(B). The notice must be mailed to the shareholder unless the shareholder has provided the QOF RIC or QOF REIT with an email address to be used for this purpose. In the manner and at the time determined by the Commissioner, the QOF RIC or QOF REIT must provide the Commissioner all data that the Commissioner specifies with respect to the amounts of capital gain dividends and the dates reported or designated by the QOF RIC or QOF REIT for each shareholder.

(3) *General limitations on the amounts of capital gain with which a date may be identified*—(i) *No identification in the absence of any capital gains with respect to qualified opportunity zone property*. If, during its taxable year, the QOF RIC or QOF REIT did not recognize long-term capital gain on any sale or exchange of qualified opportunity zone property, then no date may be identified with any capital gain dividends, or parts thereof, with respect to that year.

(ii) *Proportionality*. Reportings and designations of capital gain dividends identified with a date must be proportional for all capital gain dividends

paid with respect to the taxable year. See section 857(g)(2). Greater than *de minimis* violation of proportionality invalidates all of the purported identifications for a taxable year.

(iii) *Undistributed capital gains*. If section 852(b)(3)(D)(i) or 857(b)(3)(C)(i) requires a shareholder of a QOF RIC or QOF REIT to include a reported or designated amount in the shareholder's long-term capital gain for a taxable year, then inclusion of this amount in this manner is treated as receipt of a capital gain for purposes of this paragraph (e) and may be identified with a date.

(iv) *Gross gains*. The amount determined under paragraph (e)(4) of this section is determined without regard to any losses that may have been recognized on other sales or exchanges of qualified opportunity zone property. The losses do, however, limit the total amount of capital gain dividends that may be reported or designated under section 852(b)(3) or section 857(b)(3).

(4) *Determination of the amount of capital gain with which a date may be identified*. A QOF RIC or QOF REIT may choose to identify the date for an amount of capital gain in one of the following manners:

(i) *Simplified determination*. If, during its taxable year, the QOF RIC or QOF REIT recognizes long-term capital gain on one or more sales or exchanges of qualified opportunity zone property, then the QOF RIC or QOF REIT may identify the first day of that taxable year as the date identified with each reported or designated amount with respect to the capital gain dividends for that taxable year. A reported or designated identification is invalid in its entirety if the amount of gains that the QOF RIC or QOF REIT identifies with that date exceeds the aggregate long-term capital gains recognized on those sales or exchanges for that taxable year.

(ii) *Sale date determination*—(A) *In general*. If, during its taxable year, the QOF RIC or QOF REIT recognizes long-term capital gain on one or more sales or exchanges of qualified opportunity zone property, then the QOF RIC or QOF REIT may identify capital gain dividends, or a part thereof, with the latest date on which there was such a recognition. The amount of capital gain dividends so identified must not exceed the aggregate long-term capital gains recognized on that date from sales or exchanges of qualified opportunity zone property. A reported or designated identification is invalid in its entirety if the amount of gains that the QOF RIC or QOF REIT identifies with that date violates the preceding sentence.

(B) *Iterative application*. The process described in paragraph (e)(4)(ii)(A) of this section is applied iteratively to increasingly earlier transaction dates (from latest to earliest) until all capital gain dividends are identified with dates or there are no earlier dates in the taxable year on which the QOF RIC or QOF REIT recognized long-term capital gains with respect to a sale or exchange of qualified opportunity zone property, whichever comes first.

(f) *Applicability dates*. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

[T.D. 9889, 85 FR 1974, Jan. 13, 2020; 85 FR 19083, Apr. 6, 2020]

§ 1.1400Z2(d)–1 Qualified opportunity funds and qualified opportunity zone businesses.

(a) *Overview*. This section provides rules that an eligible entity (as defined in paragraph (a)(1) of this section) must satisfy to be a qualified opportunity fund (QOF) or a qualified opportunity zone business. Paragraphs (a)(2) through (4) of this section provide rules that eligible entities must follow to be certified as QOFs, as well as rules for the de-certification of QOFs. Paragraph (b) of this section provides rules for determining whether the property held by a QOF satisfies the *90-percent investment standard* of section 1400Z–2(d)(1) or the property held by a qualified opportunity zone business satisfies the *70-percent tangible property standard* of section 1400Z–2(d)(3)(A)(i). Paragraph (c) of this section provides rules regarding qualified opportunity zone property that a QOF must hold to satisfy the 90-percent investment standard. Paragraph (d) of this section provides rules that an eligible entity must satisfy to be a qualified opportunity zone business that is owned, in whole or in part,

by one or more QOFs. Paragraph (e) of this section provides applicability dates for this section. See § 1.1400Z2(d)–2 for rules that must be satisfied for tangible property of an eligible entity to be treated as qualified opportunity zone business property.

(1) *Eligible entity*—(i) *In general*. Except as provided in paragraph (a)(1)(ii) of this section, the term *eligible entity* means an entity that is classified as a corporation or partnership for Federal income tax purposes. In order to be treated as a QOF, an eligible entity must self-certify on an annual basis that it satisfies the requirements of paragraphs (b) and (c) of this section, as appropriate. An eligible entity is a qualified opportunity zone business if it satisfies the requirements of paragraph (d) of this section.

(ii) *Exceptions based on where an entity is created, formed, or organized*—(A) *QOFs*. An entity classified as a corporation or partnership for Federal income tax purposes (an entity) but that is not organized under the law of the United States or the law of one of the 50 states, a government of a federally recognized tribe (Indian tribal government), the District of Columbia, or a U.S. territory, is not an eligible entity and is ineligible to be a QOF. An entity described in the preceding sentence is also ineligible to be a qualified opportunity zone business, and therefore an equity interest in the entity is neither qualified opportunity zone stock nor a qualified opportunity zone partnership interest for purposes of section 1400Z–2(d)(2).

(B) *Entities organized in a U.S. territory*—(*1*) *In general*. If an entity is organized in a U.S. territory but not in one of the 50 States or the District of Columbia, the entity may be a QOF only if the entity is organized for investing in qualified opportunity zone property that relates to a trade or business operated in the U.S. territory in which the entity is organized. If an entity is organized in a U.S. territory but not in one of the 50 States or the District of Columbia, an equity interest in the entity may be qualified opportunity zone stock or a qualified opportunity zone partnership interest, as the case may be, only if the entity conducts a qualified opportunity zone business in the U.S. territory in which the entity is organized. An entity described in the preceding sentence is treated as satisfying the requirement, as applicable, of being a domestic corporation for purposes of section 1400Z–2(d)(2)(B)(i) or of being a domestic partnership for purposes of section 1400Z–2(d)(2)(C).

(*2*) *U.S. territory defined*. For purposes of this paragraph (a)(1), the term *U.S. territory* means American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, the U.S. Virgin Islands, and any other territory not under the jurisdiction of one of the 50 States, an Indian tribal government, or the District of Columbia where a qualified opportunity zone has been designated under section 1400Z–1.

(iii) *Pre-existing entities*. There is no legal barrier to a pre-existing eligible entity qualifying as a QOF or a qualified opportunity zone business, but the pre-existing eligible entity must satisfy all of the applicable requirements of section 1400Z–2, this section, and § 1.1400Z2(d)–2.

(2) *Self-certification as a QOF*. The following rules apply to the required self-certification of an eligible entity as a QOF:

(i) *Time, form, and manner*. The self-certification must be timely-filed and effected annually in such form and manner as may be prescribed by the Commissioner of Internal Revenue (Commissioner) in the Internal Revenue Service (IRS) forms or instructions, or in publications or guidance published in the Internal Revenue Bulletin (see §§ 601.601(d)(2) and 601.602 of this chapter).

(ii) *First taxable year*. The self-certification must identify the first taxable year for which the self-certification takes effect.

(iii) *First month*. The self-certification may identify the first month (in that initial taxable year) in which the self-certification takes effect.

(A) *Failure to specify first month*. If the self-certification fails to specify the month in the initial taxable year that the self-certification takes effect, then the self-certification is treated as taking effect in the first month of that taxable year.

(B) *Investments before entity's first month as QOF not eligible for deferral.* If an investment in eligible interests of an eligible entity occurs prior to the eligible entity's first month as a QOF, any election under section 1400Z–2(a)(1) made for that investment is invalid and the investment is a non-qualifying investment.

(iv) *Becoming a QOF in a month that is not the first month of the taxable year.* This paragraph (a)(2)(iv) applies to an eligible entity if its self-certification as a QOF is first effective for a month that is not the first month of that entity's taxable year.

(A) For purposes of applying section 1400Z–2(d)(1)(A) and (B) in the first year of the QOF's existence, the phrase *first six-month period of the taxable year of the fund* means the first six months each of which is in the taxable year and in each of which the entity is a QOF. Thus, if an eligible entity becomes a QOF in the seventh or later month of a 12-month taxable year, the 90-percent investment standard in section 1400Z–2(d)(1) takes into account only the QOF's assets on the last day of the QOF's taxable year.

(B) The computation of any penalty under section 1400Z–2(f)(1) does not take into account any months before the first month in which an eligible entity is a QOF.

(3) *Self-decertification of a QOF.* If a QOF chooses to self-decertify as a QOF, the following rules apply:

(i) *Form and manner.* The self-decertification must be effected in such form and manner as may be prescribed by the Commissioner in IRS forms or instructions or in publications or guidance published in the Internal Revenue Bulletin (see §§ 601.601(d)(2) and 601.602 of this chapter).

(ii) *Time.* The self-decertification becomes effective at the beginning of the month following the month specified by the taxpayer, which month must not be earlier than the month in which the taxpayer files its self-decertification as provided in paragraph (a)(3)(i) of this section.

(4) [Reserved]

(b) *Valuation of property for purposes of the 90-percent investment standard and the 70-percent tangible property standard*—(1) *In general.* An eligible entity may value its owned or leased property using the valuation methods provided in paragraphs (b)(3) and (4) of this section to determine whether—

(i) In the case of an eligible entity that has self-certified as a QOF, the assets owned or leased by the QOF satisfy the 90-percent investment standard in section 1400Z–2(d)(1); and

(ii) In the case of an eligible entity that has issued qualified opportunity zone partnership interests or qualified opportunity zone stock to a QOF, the tangible property owned or leased by the eligible entity satisfies the *70-percent tangible property standard* in section 1400Z–2(d)(3)(A)(i).

(2) *Special rules*—(i) *QOFs*—(A) *In general.* To meet the *90-percent investment standard* in section 1400Z–2(d)(1), on a semiannual basis, a QOF may value its assets using the applicable financial statement valuation method set forth in paragraph (b)(3) of this section, if the QOF has an applicable financial statement within the meaning of § 1.475(a)–4(h), or the alternative valuation method set forth in paragraph (b)(4) of this section. During each taxable year, a QOF must apply consistently the valuation method that it selects under paragraph (b) of this section to all assets valued with respect to the taxable year.

(B) *Option for QOFs to disregard recently contributed property.* A QOF may choose to determine compliance with the *90-percent investment standard* by excluding from both the numerator and denominator of the test any property that satisfies all the criteria in paragraphs (b)(2)(i)(B)(*1*) through (*3*) of this section. A QOF need not be consistent from one semiannual test to another in whether it avails itself of the option in this paragraph (b)(2)(i)(B).

(*1*) The amount of the property was received by the QOF partnership as a contribution or by the QOF corporation solely in exchange for stock of the corporation;

(*2*) The contribution or exchange occurred not more than 6 months before the test from which it is being excluded; and

(*3*) Between the date of the fifth business day after the contribution or exchange and the date of the semiannual test, the amount was held continuously

in cash, cash equivalents, or debt instruments with a term of 18 months or less.

(C) *Safe harbor for QOFs to determine whether equity in an entity is qualified opportunity zone property.* A QOF may choose to determine compliance with the *90-percent investment standard* for each semiannual testing date of the QOF by including in both the numerator and denominator of the test the equity of each entity the QOF holds on that testing date that satisfies all the criteria in paragraph (b)(2)(i)(C)(*1*) or (*2*) of this section.

(*1*) The entity was a qualified opportunity zone business for at least 90 percent of the QOF's cumulative holding period for that equity of the entity—

(*i*) Beginning on the date the QOF's self-certification as a QOF is first effective; and

(*ii*) Ending on the last day of the entity's most recent taxable year ending on or before the semiannual testing date of the QOF.

(*2*) An entity that would not be a qualified opportunity zone business as of the end of its last taxable year ending on or before a semiannual testing date of the QOF is a qualified opportunity zone business with respect to the QOF for that taxable year of the entity if—

(*i*) A cure is achieved for the entity under paragraph (d)(6) of this section; and

(*ii*) The QOF files its Federal income tax return for the taxable year of the QOF containing the testing date on a date that is timely (taking extensions into account) and that is not earlier than when that cure is achieved.

(ii) *Qualified opportunity zone businesses*—(A) *In general.* For purposes of the fraction set forth in paragraph (d)(2)(ii)(A) of this section, the owned or leased tangible property of a qualified opportunity zone business may be valued using the applicable financial statement valuation method set forth in paragraph (b)(3) of this section, if the qualified opportunity zone business has an applicable financial statement within the meaning of § 1.475(a)–4(h), or the alternative valuation method set forth in paragraph (b)(4) of this section. During each taxable year, the valuation method selected under this paragraph (b) must be applied consistently to all tangible property valued with respect to the taxable year.

(B) *Five-percent zone taxpayer.* If a taxpayer both has self-certified as a QOF and holds an equity interest in an eligible entity that is tested as a qualified opportunity zone business, then that taxpayer may value the eligible entity's tangible property for purposes of satisfying the *70-percent tangible property standard* using the same valuation methodology under this paragraph (b) that the taxpayer uses for determining its own compliance with the 90-percent investment standard (compliance methodology), provided that no other equity holder in the eligible entity is a five-percent zone taxpayer. If two or more taxpayers that have self-certified as QOFs hold equity interests in the eligible entity and at least one of them is a five-percent zone taxpayer, then the values of the eligible entity's tangible property may be calculated using the compliance methodology that both is used by a five-percent zone taxpayer and that produces the highest percentage of qualified opportunity zone business property for the eligible entity for purposes of the *70-percent tangible property standard.* A *five-percent zone taxpayer* is a taxpayer that has self-certified as a QOF and that holds stock in the entity (if it is a corporation) representing at least 5 percent in voting rights and value or holds an interest of at least 5 percent in the profits and capital of the entity (if it is a partnership).

(*1*) *Example.* The example in paragraph (b)(2)(ii)(B)(*2*) of this section illustrates the principles of paragraph (b)(2)(ii)(B) of this section.

(*2*) *Example.* Entity JH is a corporation that has issued only one class of stock and that conducts a trade or business. Taxpayer X holds 94% of the JH stock, and Taxpayer Y holds the remaining 6% of that stock. (Thus, both X and Y are five percent zone taxpayers within the meaning of paragraph (b)(2)(ii)(B) of this section.) JH does not have an applicable financial statement, and, for that reason, a determination of whether JH is conducting a qualified opportunity zone business may employ the compliance methodology of X or Y. X and Y use

different compliance methodologies permitted under paragraph (b)(2)(i)(A) of this section for purposes of satisfying the *90-percent investment standard* of section 1400Z–2(d)(1). Under X's compliance methodology (which is based on X's applicable financial statement), 65% of the tangible property owned or leased by JH's trade or business is qualified opportunity zone business property. Under Y's compliance methodology (which is based on Y's cost), 73% of the tangible property owned or leased by JH's trade or business is qualified opportunity zone business property. Because Y's compliance methodology would produce the higher percentage of qualified opportunity zone business property for JH (73%), both X and Y may use Y's compliance methodology to value JH's owned or leased tangible property. If JH's trade or business satisfies all additional requirements in section 1400Z–2(d)(3), the trade or business is a qualified opportunity zone business. Thus, if all of the additional requirements in section 1400Z–2(d)(2)(B) are satisfied, stock in JH is qualified opportunity zone stock in the hands of a taxpayer that has self-certified as a QOF.

(iii) *Inventory*. In determining whether the *90-percent investment standard* in section 1400Z–2(d)(1) or the *70-percent tangible property standard* in section 1400Z–2(d)(3)(A)(i) is satisfied, an eligible entity may choose to exclude from both the numerator and denominator of the applicable test the value of all inventory (including raw materials) of the trade or business, if applied consistently within a taxable year of the eligible entity.

(3) *Applicable financial statement valuation method*—(i) *In general*. Under the applicable financial statement valuation method set forth in this paragraph (b)(3), the value of each property that is owned or leased by an eligible entity is the value of that asset as reported on the eligible entity's applicable financial statement for the relevant reporting period.

(ii) *Requirement for selection of method*. An eligible entity may select the applicable financial statement valuation method set forth in this paragraph (b)(3) to value an asset leased by the eligible entity only if the applicable financial statement of the eligible entity is prepared according to U.S. generally accepted accounting principles (GAAP) and requires an assignment of value to the lease of the asset.

(4) *Alternative valuation method*—(i) *In general*. Under the alternative valuation method set forth in this paragraph (b)(4), the value of the property owned by an eligible entity is calculated under paragraph (b)(4)(ii) of this section, and the value of the property leased by an eligible entity is calculated under paragraph (b)(4)(iii) of this section.

(ii) *Property owned by an eligible entity*—(A) *Property purchased or constructed*. The value of each property owned by an eligible entity that is acquired by purchase for fair market value or constructed for fair market value is the eligible entity's unadjusted cost basis of the asset under section 1012 or section 1013. Solely for purposes of this paragraph (b)(4)(ii)(A), the acquisition by a QOF of qualified opportunity zone stock or a qualified opportunity zone partnership interest is treated as a purchase of such interest by the QOF.

(iii) *Property leased by an eligible entity*—(A) *In general*. The value of each property that is leased by an eligible entity is equal to the present value of the leased property as defined in paragraph (b)(4)(iii)(C) of this section.

(B) *Discount rate*. For purposes of calculating present value under paragraph (b)(4)(iii) of this section, the discount rate is the short-term applicable Federal rate under section 1274(d)(1), based on semiannual compounding, for the month in which the eligible entity enters into the lease. For purposes of the preceding sentence, the three month rule in section 1274(d)(2) does not apply to determine the applicable Federal rate.

(C) *Present value*. For purposes of paragraph (b)(4)(iii) of this section, present value of a leased property—

(*1*) Is equal to the sum of the present values of each payment under the lease for the property;

(*2*) Is calculated at the time the eligible entity enters into the lease for the property; and

(*3*) Once calculated, is used as the value for the property by the eligible

entity for all testing dates during the term of the lease for purposes of the *90-percent investment standard* or the *70-perecent tangible property standard*.

(D) *Term of a lease*. For purposes of paragraph (b)(4)(iii) of this section, the term of a lease includes periods during which the lessee may extend the lease at a pre-defined market rate rent. For nonresidential real property or residential real property, pre-defined rent does not include the option to renew at fair market value, determined at the time of renewal. The terms of the pre-defined rent must satisfy the following criteria:

(*1*) *General rule*. The terms of the pre-defined rent are market rate (that is, the terms of the pre-defined rent reflect common, arms-length market pricing in the locale that includes the qualified opportunity zone as determined under section 482 and all section 482 regulations in this chapter) at the time the lease is entered into.

(*2*) *Rebuttable presumption regarding leases not between related persons*. There will be a rebuttable presumption that the terms of the extension of the lease are market rate for leases not between related persons (within the meaning of section 1400Z–2(e)(2)), and thus, the parties to the lease are not required to perform a section 482 analysis.

(*3*) *Exception for state, local, and Indian tribal governments*. For purposes of this paragraph (b)(4)(iii)(D), tangible property acquired by lease from a state or local government, or an Indian tribal government, is not considered tangible property acquired by lease from a related person.

(c) *Qualified opportunity zone property*—(1) *In general*. Pursuant to section 1400Z–2(d)(2)(A), the following property is *qualified opportunity zone property:*

(i) Qualified opportunity zone stock as defined in paragraph (c)(2) of this section;

(ii) Qualified opportunity zone partnership interest as defined in paragraph (c)(3) of this section; and

(iii) Qualified opportunity zone business property as defined in § 1.1400Z2(d)–2.

(2) *Qualified opportunity zone stock*—(i) *In general*. Except as provided in paragraph (c)(2)(ii) of this section, if an eligible entity is classified as a corporation for Federal income tax purposes (corporation), then an equity interest (stock) in the eligible entity is *qualified opportunity zone stock* if the requirements described in this paragraph (c)(2)(i) are satisfied:

(A) *Date of acquisition*. The stock is acquired by a QOF after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash;

(B) *Qualified opportunity zone business*. As of the time the stock was issued, the corporation was a qualified opportunity zone business as defined in section 1400Z–2(d)(3) and paragraph (d) of this section (or, in the case of a new corporation, the corporation was being organized for purposes of being such a qualified opportunity zone business); and

(C) *90-percent qualified opportunity zone property holding period*—(*1*) *Cumulative holding period test*. During at least 90 percent of the QOF's holding period for the corporation's stock, determined on a cumulative basis in accordance with paragraph (c)(2)(i)(C)(*2*) of this section, the corporation qualified as a qualified opportunity zone business.

(*2*) *Semiannual qualified opportunity zone business test*. For purposes of determining satisfaction of the cumulative 90-percent qualified opportunity zone property holding period test described in paragraph (c)(2)(i)(C)(*1*) of this section, the determination of whether a corporation engaged in a trade or business qualifies as a qualified opportunity zone business may be made by the QOF on a semiannual basis pursuant to section 1400Z–2(d)(1). However, a QOF may choose to apply the safe harbor rule in paragraph (b)(2)(i)(C) of this section to make this determination.

(ii) *Redemptions of stock*. Pursuant to section 1400Z–2(d)(2)(B)(ii), the following rules apply for purposes of determining whether stock in a corporation qualifies as qualified opportunity zone stock:

(A) *Redemptions from taxpayer or related person*. Stock acquired by a QOF is not treated as qualified opportunity zone stock if, at any time during the 4-year period beginning on the date 2 years before the issuance of the stock, the corporation issuing the stock purchased either directly or indirectly any

of its stock from the QOF or from a person related (within the meaning of section 1400Z–2(e)(2)) to the QOF. Even if the purchase occurs after the issuance, the stock was never qualified opportunity zone stock.

(B) *Significant redemptions*—(*1*) *In general*. Stock issued by a corporation is not treated as qualified opportunity zone stock if, at any time during the 2-year period beginning on the date one year before the issuance of the stock, the corporation made one or more purchases of more than a de minimis amount of its stock and the purchased stock has an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of its stock as of the beginning of the 2-year period. The aggregate value is determined as of the time of the stock purchases. Even if one or more of the disqualifying purchases occurs after the issuance, the stock was never qualified opportunity zone stock.

(*2*) *De minimis amount*. For purposes of this paragraph (c)(2)(ii)(B), stock acquired from the taxpayer or a related person exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of the stock held by the taxpayer and related persons (within the meaning of section 1400Z–2(e)(2)) is acquired. The rules in the following sentences of this paragraph (c)(2)(ii)(B)(*2*) apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

(C) *Treatment of certain transactions*. If any transaction is treated under section 304(a) as a distribution in redemption of the stock of any corporation, for purposes of paragraphs (c)(2)(ii)(A) and (B) of this section, that corporation is treated as purchasing an amount of its stock equal to the amount that is treated as such a distribution under section 304(a).

(D) *Principles of § 1.1202–2(c) and (d)*. The principles of § 1.1202–2(c) and (d) apply in determining whether stock is redeemed or purchased for purposes of paragraph (c)(2)(ii) of this section.

(iii) *Reorganizations of corporations otherwise qualifying as qualified opportunity zone businesses*—(A) *Qualification as qualified opportunity zone stock*. Stock that meets all of the requirements of paragraph (c)(2)(i) of this section except for the requirement in paragraph (c)(2)(i)(A) of this section is qualified opportunity zone stock if it is received solely in exchange for qualified opportunity zone stock in a transaction described in section 381(a)(2). The requirements in paragraphs (c)(2)(i)(B) and (C) of this section must be met with respect to both the stock held before such transaction and the stock for which it is exchanged in such transaction.

(B) *Satisfaction of original use and substantial improvement tests*. The requirements of § 1.1400Z2(d)–2 apply to property of a qualified opportunity zone business acquired from a qualified opportunity zone business in a transaction described in section 381(a)(2) as if the acquiring corporation had held the property during the period in which the target corporation held the property. For example, an item of property must be substantially improved by the same date by which the target corporation was required to satisfy the substantial improvement test for such property.

(C) *Reorganizations of qualified opportunity zone businesses within a consolidated group*. See §§ 1.1502–14Z and 1.1504–3 for special rules applicable to consolidated groups.

(3) *Qualified opportunity zone partnership interest*—(i) *In general*. If an *eligible* entity is classified as a partnership for Federal tax purposes (partnership), any capital or profits interest (partnership interest) in the eligible entity is a *qualified opportunity zone partnership interest* if—

(A) *Date of acquisition*. The partnership interest is acquired by a QOF after December 31, 2017, from the partnership solely in exchange for cash;

(B) *Qualified opportunity zone business*. As of the time the partnership interest was acquired, the partnership

was a qualified opportunity zone business as defined in section 1400Z–2(d)(3) and paragraph (d) of this section (or, in the case of a new partnership, the partnership was being organized for purposes of being a qualified opportunity zone business); and

(C) *90-percent qualified opportunity zone property holding period*—(*1*) *Cumulative holding period test*. During at least 90-percent of the QOF's holding period for the partnership interest, determined on a cumulative basis in accordance with paragraph (c)(3)(i)(C)(*2*) of this section, the partnership qualified as a qualified opportunity zone business.

(*2*) *Semiannual qualified opportunity zone business test*. For purposes of determining satisfaction of the cumulative 90-percent qualified opportunity zone property holding period test described in paragraph (c)(3)(i)(C)(*1*) of this section, the determination of whether a partnership engaged in a trade or business qualifies as a qualified opportunity zone business is made by the QOF on a semiannual basis pursuant to section 1400Z–2(d)(1). However, a QOF may choose to apply the safe harbor rule in paragraph (b)(2)(i)(C) of this section to make this determination.

(ii) *Reorganizations of partnerships otherwise qualifying as qualified opportunity zone businesses*—(A) *Qualification as a qualified opportunity zone partnership interest*. A partnership interest that meets all of the requirements of paragraph (c)(3)(i) of this section except for the requirement in paragraph (c)(3)(i)(A) of this section is a qualified opportunity zone partnership interest if it is received solely in exchange for a qualified opportunity zone partnership interest in a merger or consolidation transaction described in section 708(b)(2)(A). The requirements in paragraphs (c)(3)(i)(B) and (C) of this section must be met with respect to both the partnership interest held before the transaction and the partnership interest for which it is exchanged in the transaction.

(B) *Satisfaction of original use and substantial improvement tests*. The requirements of §1.1400Z2(d)–2 apply to property of a qualified opportunity zone business acquired from a qualified opportunity zone business in a transaction described in section 708(b)(2)(A) as if the resulting partnership had held the property during the period in which the merging or consolidating partnership held the property. For example, an item of property must be substantially improved by the same date by which the merging or consolidating partnership was required to satisfy the substantial improvement test for such property.

(d) *Qualified opportunity zone business*—(1) *In general*. An eligible entity engaged in a trade or business within the meaning of section 162 is a *qualified opportunity zone business* if the entity satisfies, as determined at the end of its taxable year, all the criteria in paragraphs (d)(1)(i) through (*iii*) of this section. An eligible entity's status as a qualified opportunity zone business applies for the entire taxable year of the entity.

(i) Pursuant to section 1400Z–2(d)(3)(A)(i), the eligible entity engaged in the trade or business satisfies the *70-percent tangible property standard* with respect to its tangible property, as provided in paragraph (d)(2) of this section;

(ii) Pursuant to section 1400Z–2(d)(3)(A)(ii), the eligible entity engaged in the trade or business satisfies the requirements of section 1397C(b)(2), (4), and (8), as provided in paragraph (d)(3) of this section; and

(iii) Pursuant to section 1400Z–2(d)(3)(A)(iii), the eligible entity engaged in the trade or business is not described in section 144(c)(6)(B) as provided in paragraph (d)(4) of this section.

(2) *Satisfaction of 70-percent tangible property standard*—(i) *In general*. A trade or business of an eligible entity satisfies the *70-percent tangible property standard* if at least 70 percent of the tangible property owned or leased by the trade or business is qualified opportunity zone business property (as defined in §1.1400Z2(d)–2).

(ii) *Calculating percent of tangible property owned or leased in a trade or business*—(A) *In general*. Whether a trade or business of the eligible entity satisfies the *70-percent tangible property standard* set forth in paragraph (d)(2)(i) of this section is determined by a fraction—

(*1*) The numerator of which is the total value of all tangible property owned or leased by the qualified opportunity zone business that is qualified opportunity zone business property; and

(*2*) The denominator of which is the total value of all tangible property owned or leased by the qualified opportunity zone business, whether located inside or outside of a qualified opportunity zone.

(B) *Valuation*. See paragraph (b)(2)(ii) of this section for rules regarding the valuation of tangible property for purposes of the *70-percent tangible property standard*.

(3) *Operation of section 1397C requirements adopted by reference*—(i) *Gross income requirement*. Section 1400Z–2(d)(3)(A)(ii) incorporates section 1397C(b)(2), requiring that for each taxable year at least 50 percent of the gross income of a qualified opportunity zone business is derived from the active conduct of a trade or business in the qualified opportunity zone (or in multiple qualified opportunity zones). A trade or business meets the 50-percent gross income requirement in the preceding sentence if the trade or business satisfies any one of the four criteria described in paragraph (d)(3)(i)(A), (B), (C), or (D) of this section, or any criteria identified in published guidance issued by the Commissioner under § 601.601(d)(2) of this chapter.

(A) *Services performed in qualified opportunity zone based on hours*. At least 50 percent of the services performed for the trade or business are performed in a qualified opportunity zone, determined by the fraction described in paragraphs (d)(3)(i)(A)(*1*) and (*2*) of this section. Amounts paid to partners that provide services to the trade or business of a partnership are taken into account in the numerator and denominator set forth in paragraphs (d)(3)(i)(A)(*1*) and (*2*) of this section only to the extent the amounts paid to the partners are guaranteed payments for services provided to the partnership within the meaning of section 707(c).

(*1*) The numerator of the fraction is the total number of hours of services performed for the trade or business in a qualified opportunity zone during the taxable year by employees, partners that provide services to a partnership, independent contractors, and employees of independent contractors; and

(*2*) The denominator of the fraction is the total number of hours of services performed for the trade or business during the taxable year by employees, partners that provide services to a partnership, independent contractors, and employees of independent contractors.

(B) *Services performed in qualified opportunity zone based on amounts paid for services*. At least 50 percent of the services performed for the trade or business are performed in a qualified opportunity zone, determined by the fraction described in paragraphs (d)(3)(i)(B)(*1*) and (*2*) of this section. Amounts paid to partners that provide services to the trade or business of a partnership are taken into account in the numerator and denominator set forth in paragraphs (d)(3)(i)(B)(*1*) and (*2*) of this section only to the extent the amounts paid to the partners are guaranteed payments for services provided to the partnership within the meaning of section 707(c).

(*1*) The numerator of the fraction is the total amount paid by the entity for services performed in a qualified opportunity zone during the taxable year, whether by employees, partners that provide services to a partnership, independent contractors, or employees of independent contractors; and

(*2*) The denominator of the fraction is the total amount paid by the entity for services performed during the taxable year, whether by employees, partners that provide services to a partnership, independent contractors, or employees of independent contractors.

(C) *Necessary tangible property and business functions*. The tangible property of the trade or business located in a qualified opportunity zone and the management or operational functions performed in a qualified opportunity zone are each necessary for the generation of at least 50 percent of the gross income of the trade or business.

(D) *Facts and circumstances*. Based on all the facts and circumstances, at least 50 percent of the gross income of a qualified opportunity zone business is derived from the active conduct of a

trade or business in a qualified opportunity zone.

(E) *Examples*. The following examples illustrate the principles of paragraphs (d)(3)(i)(C) and (D) of this section.

(*1*) *Example 1*. A landscaping business has its headquarters in a qualified opportunity zone, its officers and employees manage the daily operations of the business (inside and outside the qualified opportunity zone) from its headquarters, and all its equipment and supplies are stored in the headquarters facilities. The activities occurring and the storage of equipment and supplies in the qualified opportunity zone are, taken together, necessary for the generation of the income of the business.

(*2*) *Example 2*. A trade or business is formed or organized under the laws of the jurisdiction within which a qualified opportunity zone is located, and the business has a P.O. Box located in the qualified opportunity zone. The mail received at that P.O. Box is fundamental to the income of the trade or business, but there is no other basis for concluding that the income of the trade or business is derived from activities in the qualified opportunity zone. The mere location of the P.O. Box is not necessary for the generation of gross income by the trade or business.

(*3*) *Example 3*. In 2019, Taxpayer X realized $w million of capital gains and within the 180-day period invested $w million in QOF Y, a qualified opportunity fund. QOF Y immediately acquired from partnership P a partnership interest in P, solely in exchange for $w million of cash. P is a real estate developer that has written plans to acquire land in a qualified opportunity zone on which it plans to construct a commercial building for lease to other trades or businesses. In 2023, P's commercial building is placed in service and is fully leased up to other trades or businesses. For the 2023 taxable year, at least 50 percent of P's gross income is derived from P's rental of its tangible property in the qualified opportunity zone. Thus, under P's facts and circumstances, P satisfies the gross income test under section 1397C(b)(2).

(ii) *Use of intangible property requirement*—(A) *In general*. Section 1400Z–2(d)(3)(A)(ii) incorporates section 1397C(b)(4), requiring that, with respect to any taxable year, a substantial portion of the intangible property of a qualified opportunity zone business is used in the active conduct of a trade or business in a qualified opportunity zone. For purposes of section 1400Z–2(d)(3)(A)(ii) and the preceding sentence, the term *substantial portion* means at least 40 percent.

(B) *Use of intangible property*. For purposes of section 1400Z–2(d)(3)(A)(ii) and paragraph (d)(3)(ii)(A) of this section, intangible property of a qualified opportunity zone business is used in the active conduct of a trade or business in a qualified opportunity zone if—

(*1*) The use of the intangible property is normal, usual, or customary in the conduct of the trade or business; and

(*2*) The intangible property is used in the qualified opportunity zone in the performance of an activity of the trade or business that contributes to the generation of gross income for the trade or business.

(iii) *Active conduct of a trade or business*—(A) *Operating real property*. Solely for purposes of section 1400Z–2(d)(3)(A), the ownership and operation (including leasing) of real property is the active conduct of a trade or business.

(B) *Lessee is responsible for certain costs*. Merely entering into a triple-net-lease with respect to real property owned by a taxpayer does not constitute the active conduct of a trade or business by such taxpayer.

(C) *Examples*. The following examples illustrate the rules of paragraph (d)(3)(iii) of this section.

(*1*) *Example 1. Mere triple-net-lease not active conduct of trade or business*—(*i*) *Facts*. Company N constructs and places into service a new, three-story office building in a qualified opportunity zone and leases the entire building to tenant X, an unrelated person, which uses the building as office space for its software development firm. This building is the only property owned by Company N. The lease agreement between Company N and tenant X is a triple-net-lease under which tenant X is responsible for all of the costs relating to the office building (for example, paying all taxes, insurance, and maintenance expenses) in addition to paying rent. Company N also maintains an office in the building with staff members

to address any issues that may arise with respect to the triple-net-lease.

(*ii*) *Analysis*. Solely for purposes of section 1400Z–2(d)(3)(A), Company N is treated as not engaged in the active conduct of a trade or business with respect to the leased office building. Company N leases the building to tenant X under a triple-net-lease, and therefore the employees of Company N do not meaningfully participate in the management or operations of the building. The fact that Company N maintains an office in the leased building with staff members to address any issues that may arise with respect to the triple-net-lease does not alter this result. Therefore, Company N does not conduct an active trade or business in a qualified opportunity zone.

(*2*) *Example 2. Triple-net-lease and managerial and operational activities can constitute active conduct of trade or business*—(*i*) *Facts*. Company N constructs and places into service a new, three-story mixed-use building in a qualified opportunity zone and leases a floor to each of unrelated tenants X, Y, and Z, respectively. This building is the only property owned by Company N. The lease agreement between Company N and tenant X is a triple-net-lease under which tenant X is responsible for all of the costs relating to the third floor of the building (for example, paying all such taxes, insurance, and maintenance expenses) in addition to paying rent. The lease agreement between Company N and tenant Y is not a triple-net-lease and employees of Company N manage and operate the second floor of the building. Likewise, the lease agreement between Company N and tenant Z is not a triple-net-lease and employees of Company N manage and operate the first floor of the building. Company N maintains an office in the building, which the employees regularly use to carry out their managerial and operational duties with respect to the first and second floors, and address any other issues that may arise with respect to the three leases.

(*ii*) *Analysis*. Solely for purposes of section 1400Z–2(d)(3)(A), Company N is treated as engaged in the active conduct of a trade or business with respect to the leased mixed-use building. While Company N leases the third floor of the building to tenant X merely under a triple-net-lease, and therefore the employees of Company N do not meaningfully participate in the management or operations of that floor, the employees of Company N meaningfully participate in the management and operations of the first and second floors of the leased building. Therefore, in carrying out the overall leasing business of Company N with respect to the mixed-use building, employees of Company N conduct meaningful managerial and operational activities. As a result, Company N conducts an active trade or business in a qualified opportunity zone.

(iv) *Nonqualified financial property limitation*. Section 1400Z–2(d)(3)(A)(ii) incorporates section 1397C(b)(8), which requires that in each taxable year less than 5 percent of the average of the aggregate unadjusted bases of the property of a qualified opportunity zone business is attributable to nonqualified financial property. Section 1397C(e)(1), which defines the term *nonqualified financial property* for purposes of section 1397C(b)(8), excludes from that term reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less (working capital assets) and debt instruments described in section 1221(a)(4).

(v) *Safe harbor for reasonable amount of working capital*. Solely for purposes of applying section 1397C(e)(1) to the definition of a qualified opportunity zone business under section 1400Z–2(d)(3), working capital assets are treated as reasonable in amount for purposes of sections 1397C(b)(2) and 1400Z–2(d)(3)(A)(ii), if all of the requirements in paragraphs (d)(3)(v)(A) through (C) of this section are satisfied.

(A) *Designated in writing*. These amounts are designated in writing for the development of a trade or business in a qualified opportunity zone (as defined in section 1400Z–1(a)), including when appropriate the acquisition, construction, and/or substantial improvement of tangible property in such a zone.

(B) *Reasonable written schedule*. There is a written schedule consistent with the ordinary start-up of a trade or

business for the expenditure of the working capital assets. Under the schedule, the working capital assets must be spent within 31 months of the receipt by the business of the assets.

(C) *Property consumption consistent.* The working capital assets are actually used in a manner that is substantially consistent with the writing and written schedule described in paragraphs (d)(3)(v)(A) and (B) of this section. If consumption of the working capital assets is delayed by waiting for governmental action the application for which is complete, that delay does not cause a failure of this paragraph (d)(3)(v)(C).

(D) *Federally declared disasters.* If the qualified opportunity zone business is located in a qualified opportunity zone within a federally declared disaster (as defined in section 165(i)(5)(A)), the qualified opportunity zone business may receive not more than an additional 24 months to consume its working capital assets, as long as it otherwise meets the requirements of paragraph (d)(3)(v) of this section.

(E) *Ability of a single business to benefit from more than a single application of the safe harbor.* A business may benefit from multiple overlapping or sequential applications of the working capital safe harbor, provided that each application independently satisfies all of the requirements in paragraphs (d)(3)(v)(A) through (C) of this section.

(vi) *Safe harbor for section 1397C requirements other than ''sin business'' prohibition*—(A) *Maximum 62-month safe harbor for start-up businesses.* Property described in paragraphs (d)(3)(vi)(B), (C), and (D) of this section may benefit from one or more 31-month periods, for a total of 62 months, in the form of multiple overlapping or a sequential application of the working capital safe harbor if—

(*1*) Each application independently satisfies all of the requirements in paragraphs (d)(3)(v)(A) through (C) of this section;

(*2*) The working capital assets from an expiring 31-month period were expended in accordance with the requirements in paragraphs (d)(3)(v)(A) through (C) of this section;

(*3*) The subsequent infusions of working capital assets form an integral part of the plan covered by the initial working capital safe harbor period; and

(*4*) Each overlapping or sequential application of the working capital safe harbor includes a substantial amount of working capital assets (which may include debt instruments described in section 1221(a)(4)).

(B) *Safe harbor for gross income derived from the active conduct of business.* Solely for purposes of applying the 50-percent test in section 1397C(b)(2) to the definition of a qualified opportunity zone business in section 1400Z–2(d)(3), if any gross income is derived from property that paragraph (d)(3)(v) of this section treats as a reasonable amount of working capital, then that gross income is counted toward satisfaction of the 50-percent test.

(C) *Safe harbor for use of intangible property.* Solely for purposes of applying the use requirement in section 1397C(b)(4) to the definition of a qualified opportunity zone business under section 1400Z–2(d)(3), intangible property purchased or licensed by the trade or business, pursuant to the reasonable written plan with a written schedule for the expenditure of the working capital, satisfies the use requirement during any period in which the business is proceeding in a manner that is substantially consistent with paragraphs (d)(3)(v)(A) through (C) of this section.

(D) *Safe harbor for working capital and property on which working capital is being expended*—(*1*) *Working capital.* If paragraph (d)(3)(v) of this section treats property of an entity that would otherwise be nonqualified financial property as being a reasonable amount of working capital because of compliance with the three requirements of paragraphs (d)(3)(v)(A) through (C) of this section, the entity satisfies the requirements of section 1400Z–2(d)(2)(D)(i) only during the working capital safe harbor period(s) for which the requirements of paragraphs (d)(3)(v)(A) through (C) of this section are satisfied; however such property is not qualified opportunity zone business property for any purpose.

(*2*) *Tangible property acquired with covered working capital.* If tangible property referred to in paragraph (d)(3)(v)(A) of this section is expected to satisfy the requirements of section

1400Z–2(d)(2)(D)(i) as a result of the planned expenditure of working capital described in paragraph (d)(3)(v)(A), and is purchased, leased, or improved by the trade or business, pursuant to the written plan for the expenditure of the working capital, then the tangible property is treated as qualified opportunity zone business property satisfying the requirements of section 1400Z–2(d)(2)(D)(i), during that and subsequent working capital periods the property is subject to, for purposes of the 70-percent tangible property standard in section 1400Z–2(d)(3).

(vii) *Examples*. The following examples illustrate the rules of paragraphs (d)(3)(v) and (vi) of this section.

(A) *Example 1. General application of working capital safe harbor—(1) Facts*. QOF F creates a domestic C corporation E to open a fast-food restaurant and acquires almost all of the equity of E in exchange for cash. E has a written plan and a 20-month schedule for the use of this cash to establish the restaurant. Among the planned uses for the cash are identification of favorable locations in the qualified opportunity zone, leasing a building suitable for such a restaurant, outfitting the building with appropriate equipment and furniture (both owned and leased), necessary security deposits, obtaining a franchise and local permits, and the hiring and training of kitchen and wait staff. Not-yet-disbursed amounts were held in assets described in section 1397C(e)(1), and these assets were eventually expended in a manner consistent with the plan and schedule.

(*2*) *Analysis*. E's use of the cash qualifies for the working capital safe harbor described in paragraph (d)(3)(v) of this section.

(B) *Example 2. Multiple applications of working capital safe harbor—(1) Facts*. QOF G creates a domestic C corporation H to start a new technology company and acquires equity of H in exchange for cash on Date 1. In addition to H's rapid deployment of capital received from other equity investors, H writes a plan with a 30-month schedule for the use of the Date 1 cash. The plan describes use of the cash to research and develop a new technology (Technology), including paying salaries for engineers and other scientists to conduct the research, purchasing, and leasing equipment to be used in research and furnishing office and laboratory space. Approximately 18 months after Date 1, on Date 2, G acquires additional equity in H for cash, and H writes a second plan. This new plan has a 25-month schedule for the development of a new application of existing software (Application), to be marketed to government agencies. Among the planned uses for the cash received on Date 2 are paying development costs, including salaries for software engineers, other employees, and third-party consultants to assist in developing and marketing the new application to the anticipated customers. Not-yet-disbursed amounts that were scheduled for development of the Technology and the Application were held in assets described in section 1397C(e)(1), and these assets were eventually expended in a manner substantially consistent with the plans and schedules for both the Technology and the Application.

(*2*) *Analysis*. H's use of both the cash received on Date 1 and the cash received on Date 2 qualifies for the working capital safe harbor described in paragraph (d)(3)(v) of this section.

(C) *Example 3. General application of working capital safe harbor—(1) Facts*. In 2019, Taxpayer H realized $w million of capital gains and within the 180-day period invested $w million in QOF T, a qualified opportunity fund. QOF T immediately acquired from partnership P a partnership interest in P, solely in exchange for $w million of cash. P immediately placed the $w million in working capital assets, which remained in working capital assets until used. P had written plans to acquire land in a qualified opportunity zone on which it planned to construct a commercial building. Of the $w million, $x million was dedicated to the land purchase, $y million to the construction of the building, and $z million to ancillary but necessary expenditures for the project. The written plans provided for purchase of the land within a month of receipt of the cash from QOF T and for the remaining $y and $z million to be spent within the next 30 months on construction of the building and on the

ancillary expenditures. All expenditures were made on schedule, consuming the $w million. During the taxable years that overlap with the first 31-month period, P had no gross income other than that derived from the amounts held in those working capital assets. Prior to completion of the building, P's only assets were the land it purchased, the unspent amounts in the working capital assets, and P's work in process as the building was constructed.

(*2*) *Analysis*—P met the three requirements of the safe harbor provided in paragraphs (d)(3)(v)(A) through (C) of this section. P had a written plan to spend the $w received from QOF T for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone, as defined in section 1400Z–1(a). P had a written schedule consistent with the ordinary start-up for a business for the expenditure of the working capital assets. And, finally, P's working capital assets were actually used in a manner that was substantially consistent with its written plan and the ordinary start-up of a business. First, the $x million, the $y million, and the $z million are treated as reasonable in amount for purposes of sections 1397C(b)(2) and 1400Z–2(d)(3)(A)(ii). Second, because P had no other gross income during the 31 months at issue, 100 percent of P's gross income during that time is treated as derived from an active trade or business in the qualified opportunity zone for purposes of satisfying the 50-percent test of section 1397C(b)(2). Third, for purposes of satisfying the requirement of section 1397C(b)(4), during the period of land acquisition and building construction a substantial portion of P's intangible property is treated as being used in the active conduct of a trade or business in the qualified opportunity zone. Fourth, all of the facts described are consistent with QOF T's interest in P being a qualified opportunity zone partnership interest for purposes of satisfying the 90-percent investment standard in section 1400Z–2(d)(1).

(*3*) *Analysis if P had purchased an existing building*. The conclusions would also apply if P's plans had been to buy and substantially improve a pre-existing commercial building. In addition, the fact that P's basis in the building has not yet doubled would not cause the building to fail to satisfy section 1400Z–2(d)(2)(D)(i)(III).

(D) *Example 4. Multiple applications of working capital safe harbor to tangible property*—(*1*) *Facts*. QOF A forms a domestic C corporation B to develop a large mixed-use real estate development that will consist of commercial and residential real property, owning almost all of the equity of B in exchange for cash. To raise additional working capital for the mixed-use real estate development, B also will borrow cash under a new revolving credit agreement with an unrelated lender. B has a master written plan for the completion of the commercial and residential real property over a 55-month period. The plan provides that the commercial real property will be completed over a 30 month schedule and subsequently, the residential real property will be completed over a 25 month schedule. The plan further provides that a portion of the commercial real property is unable to be used in a trade or business after the completion of the commercial real property since that portion of the commercial real property will be unusable during the residential construction phase. Pursuant to B's original master plan for the completion of the real estate development, QOF A acquires additional equity in B for cash after the completion of the commercial development phase, and B commences use of those working capital assets for residential development phase.

(*2*) *Analysis*. B's use of the cash for the commercial and residential phase qualified for the working capital safe harbor described in paragraph (d)(3)(v) of this section. In addition, all of B's commercial real property developed pursuant to B's original master plan is treated as qualified opportunity zone business property under paragraph (d)(3)(vi)(D) of this section.

(viii) *Safe harbor for property on which working capital is being expended*—(A) *In general*. If paragraph (d)(3)(v) of this section treats property that would otherwise be nonqualified financial property as being a reasonable amount of working capital because of compliance

with the three requirements of paragraphs (d)(3)(v)(A) through (C) of this section and if the tangible property referred to in paragraph (d)(3)(v)(A) is expected to satisfy the requirements of section 1400Z–2(d)(2)(D)(i) as a result of the planned expenditure of those working capital assets, then tangible property purchased, leased, or improved by the trade or business, pursuant to the written plan for the expenditure of the working capital assets, is treated as qualified opportunity zone business property satisfying the requirements of section 1400Z–2(d)(2)(D)(i), during that and subsequent working capital periods the property is subject to, for purposes of the *70-percent tangible property standard* in section 1400Z–2(d)(3).

(B) *Example. Multiple applications of working capital safe harbor to tangible property*—(i) *Facts.* B also borrows cash and forms a domestic C corporation B to develop a large mixed-use real estate development that will consist of commercial and residential real property, owning almost all of the equity of B in exchange for cash. QOF A has a master written plan for the completion of the commercial and residential real property over a 55 month period. The plan provides that the commercial real property will be completed over a 30 month schedule and subsequently, the residential real property will be completed over a 25 month schedule. The plan further provides that a portion of the commercial real property is unable to be used in a trade or business after the completion of the commercial real property since that portion of the commercial real property will be unusable during the residential construction phase. Pursuant to B's original master plan for the completion of the real estate development, QOF A acquires additional equity in B for cash after the completion of the commercial development phase, and B commences use of those working capital assets for residential development phase.

(*ii*) *Analysis.* B's use of the cash for the commercial and residential phase qualified for the working capital safe harbor described in paragraph (d)(3)(v) of this section. In addition, all of B's commercial real property developed pursuant to B's original master plan is treated as qualified opportunity zone business property under paragraph (d)(3)(viii) of this section.

(ix) *Real property straddling a qualified opportunity zone.* For purposes of satisfying the requirements in this paragraph (d)(3) in the case of real property that straddles a qualified opportunity zone, a qualified opportunity zone is the location of services, tangible property, or business functions if—

(A) The trade or business uses the portion of the real property located within a qualified opportunity zone in carrying out its business activities;

(B) The trade or business uses the real property located outside of a qualified opportunity zone in carrying out its business activities;

(C) The amount of the real property located within a qualified opportunity zone is substantial compared to the amount of real property located outside of a qualified opportunity zone; and

(D) The real property located in the qualified opportunity zone is contiguous to part, or all, of the real property located outside of the qualified opportunity zone.

(E) In general, one of the two methods in paragraph (d)(3)(ix)(E)(*1*) and (*2*) of this section may be chosen to determine whether the amount of real property located in the qualified opportunity zone is substantial compared to the amount of real property located outside the qualified opportunity zone.

(*1*) *Square footage test.* If the amount of real property based on square footage located within the qualified opportunity zone is greater than the amount of real property based on square footage outside of the qualified opportunity zone, and the real property outside of the qualified opportunity zone is contiguous to part or all of the real property located inside the qualified opportunity zone, then all of the property is deemed to be located within a qualified opportunity zone. The test in this paragraph (d)(3)(ix)(E)(*1*) is carried out at the time at which the subject real property is acquired.

(*2*) *Unadjusted cost test.* If the unadjusted cost of the real property located inside a qualified opportunity zone is greater than the unadjusted cost of the real property outside the qualified opportunity zone, and the

real property outside of the qualified opportunity zone is contiguous to all or part of the real property located inside the qualified opportunity zone, then all of the property is deemed to be located within a qualified opportunity zone. The unadjusted cost basis of property acquired as a single tract is presumed to be allocated on the basis of the square footage of the property. The test in this paragraph (d)(3)(ix)(E)(*2*) is carried out at the time at which the subject real property is acquired.

(F) For purposes of the two tests described in paragraph (d)(3)(ix)(E)(*1*) and (*2*) of this section, two or more tracts or parcels of land are contiguous if they share common boundaries or would share common boundaries but for the interposition of a road, street, railroad, stream or similar property. Tracts or parcels of land which touch only at a common corner are not contiguous.

(x) *Example*. The following example illustrates the rules of paragraph (d)(3) of this section—

(A) *Facts*. In 2019, Taxpayer H realized $w million of capital gains and within the 180-day period invested $w million in QOF T, a qualified opportunity fund. QOF T immediately acquired from partnership P a partnership interest in P, solely in exchange for $w million of cash. P immediately placed the $w million in working capital assets, which remained in working capital assets until used. P had written plans to acquire land in a qualified opportunity zone on which it planned to construct a commercial building. Of the $w million, $x million was dedicated to the land purchase, $y million to the construction of the building, and $z million to ancillary but necessary expenditures for the project. The written plans provided for purchase of the land within a month of receipt of the cash from QOF T and for the remaining $y and $z million to be spent within the next 30 months on construction of the building and on the ancillary expenditures. All expenditures were made on schedule, consuming the $w million. During the taxable years that overlap with the first 31-month period, P had no gross income other than that derived from the amounts held in those working capital assets. Prior to completion of the building, P's only assets were the land it purchased, the unspent amounts in the working capital assets, and P's work in process as the building was constructed.

(B) *Analysis*—(*1*) P met the three requirements of the safe harbor provided in paragraph (d)(3)(v) of this section. P had a written plan to spend the $w received from QOF T for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone, as defined in section 1400Z–1(a). P had a written schedule consistent with the ordinary start-up for a business for the expenditure of the working capital assets. And, finally, P's working capital assets were actually used in a manner that was substantially consistent with its written plan and the ordinary start-up of a business. Therefore, the $x million, the $y million, and the $z million are treated as reasonable in amount for purposes of sections 1397C(b)(2) and 1400Z–2(d)(3)(A)(ii).

(*2*) Because P had no other gross income during the 31 months at issue, 100 percent of P's gross income during that time is treated as derived from an active trade or business in the qualified opportunity zone for purposes of satisfying the 50-percent test of section 1397C(b)(2).

(*3*) For purposes of satisfying the requirement of section 1397C(b)(4), during the period of land acquisition and building construction a substantial portion of P's intangible property is treated as being used in the active conduct of a trade or business in the qualified opportunity zone.

(*4*) All of the facts described are consistent with QOF T's interest in P being a qualified opportunity zone partnership interest for purposes of satisfying the *90-percent investment standard* in section 1400Z–2(d)(1).

(C) *Analysis if P had purchased an existing building*. The conclusions in paragraph (d)(3)(x)(B) of this section would also apply if P's plans had been to buy and substantially improve a pre-existing commercial building. In addition, the fact that P's basis in the building has not yet doubled would not cause the building to fail to satisfy section 1400Z–2(d)(2)(D)(i)(III).

(4) *Trade or businesses described in section 144(c)(6)(B) not eligible*—(i) Pursuant to section 1400Z–2(d)(3)(A)(iii), the following trades or businesses, and businesses leasing more than a de minimis amount of property to the following trades or businesses, cannot qualify as a qualified opportunity zone business:

(A) Any private or commercial golf course;

(B) Country club;

(C) Massage parlor;

(D) Hot tub facility;

(E) Suntan facility;

(F) Racetrack or other facility used for gambling; or

(G) Any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

(ii) De minimis amounts of gross income attributable to a business described in section 144(c)(6)(B) will not cause a trade or business to fail to be a qualified opportunity zone business.

(iii) The term *de minimis amount of property*, used in paragraph (d)(4)(i) of this section, means less than 5 percent of the net rentable square feet for real property and less than 5 percent of the value for all other tangible property. The term *de minimis amount of gross income*, used in paragraph (d)(4)(ii) of this section, means less than 5 percent of the gross income of the qualified opportunity zone business may be attributable to the types of business described in section 144(c)(6)(B).

(iv) The following examples illustrate the rules of paragraph (d)(4) of this section:

(A) *Example 1.* Entity A is a QOF that meets the requirements of section 1400Z–2(d)(1). Entity A owns qualified opportunity zone stock in a domestic corporation described in section 1400Z–2(d)(2)(B), which operates a hotel located in a qualified opportunity zone that qualifies as a trade or business. As part of that trade or business, the hotel operates a spa that provides massages and other therapies. Less than 5 percent of the hotel's total gross income is attributable to the spa, and less than 5 percent of the net rentable square feet for real property and less than 5 percent of the value for all other tangible property is attributable to the spa. As a result, the operation of the spa, which is a business described in section 144(c)(6)(B), will not prevent the operation of the hotel from qualifying as a qualified opportunity zone business.

(B) *Example 2—(1) Facts.* Entity B is a qualified opportunity zone business that meets the requirements of section 1400Z–2(d)(3). Entity B plans to acquire a commercial golf course that consists of land and other related buildings and equipment in a qualified opportunity zone, that will satisfy each requirement for qualified opportunity zone business property set forth in section 1400Z–2(d)(2)(D). Instead of directly managing and operating the commercial golf course business, Entity B will lease the land and other related buildings and equipment to a third party to manage and operate the commercial golf course. The leased real property represents more than 5 percent of the net rentable square feet of Entity B's real property and the leased and other tangible property represents more than 5 percent of the value for all other tangible property of Entity B.

(*2*) *Analysis.* Because a golf course is prohibited from being a qualified trade or business under section 1400Z–2(d)(3)(A)(iii), the leasing arrangement will cause Entity B to fail to be a qualified opportunity zone business regardless of the satisfaction of each requirement set forth in section 1400Z–2(d)(2)(D).

(C) *Example 3—(1) Facts.* Entity B meets the explicit requirements of section 1400Z–2(d)(1) and has certified itself as a QOF. Entity B owns a commercial golf course that consists of land and other related buildings and equipment in a qualified opportunity zone, and the land and buildings satisfy all explicit requirements (in section 1400Z–2(d)(2)(D)) to be qualified opportunity zone business property. Entity B manages and operates the commercial golf course business, but does not manage or operate any other trade or business not described in section 144(c)(6)(B) (listing businesses not eligible to be a qualified opportunity zone business pursuant to section 1400Z–2(d)(3)(A)(iii)). Entity B chose to operate the commercial golf course through Entity B, rather than through a qualified opportunity zone business, in order to avoid the requirement in section

1400Z–2(d)(3)(A)(iii), which provides that a qualified opportunity zone business cannot operate a commercial golf course due to the inclusion of that trade or business in section 144(c)(6)(B).

(*2*) *Analysis*. The ownership and operation of the golf course at the QOF level will not disqualify the QOF because the prohibition on businesses described in section 144(c)(6)(B) is not applicable at the QOF level. In addition, if each requirement set forth in section 1400Z–2(d)(2)(D) is satisfied, the property used in the commercial golf course will qualify as qualified opportunity zone business property held by Entity B for purposes of section 1400Z–2(d)(2)(A).

(5) *Tangible property of a qualified opportunity zone business that ceases to be qualified opportunity zone business property*. For qualified opportunity zone businesses, tangible property that ceases to be qualified opportunity zone business property shall continue to be treated as qualified opportunity zone business property for the lesser of five years after the date on which such tangible property ceases to be so qualified or the date on which such tangible property is no longer held by the qualified opportunity zone business. However, tangible property is not eligible for the benefits provided in this paragraph (d)(5) unless the tangible property ceasing to qualify as qualified opportunity zone business property was qualified opportunity zone business property used by a qualified opportunity zone business in a qualified opportunity zone for two years. For purposes of this paragraph (d)(5), tangible property purchased, leased, or improved by a trade or business, that is treated as satisfying the requirements of section 1400Z–2(d)(2)(D)(i) during that working capital safe harbor period pursuant to paragraph (d)(3)(v) of this section or that 30-month substantial improvement period described in §1.1400Z2(d)–2(b)(4), is not treated as used by a qualified opportunity zone business in a qualified opportunity zone for any portion of the two year period described in this paragraph (d)(5).

(6) *Cure period for qualified opportunity zone businesses*. (i) For purposes of the *90-percent qualified opportunity zone business holding period* requirements set forth in sections 1400Z–2(d)(2)(B)(i)(III), 1400Z–2(d)(2)(C)(iii), and 1400Z–2(d)(2)(D)(i)(III), if a trade or business causes the QOF to fail the *90-percent investment standard* on a semiannual testing date, the QOF may treat the stock or partnership interest in that trade or business as qualified opportunity zone property for that semiannual testing date provided the trade or business corrects the failure within 6 months of the date on which the stock or partnership interest lost its qualification.

(ii) If the failure occurs on the last testing date of the taxable year, the six-month cure period described in paragraph (d)(6)(i) of this section is available to the QOF only if the QOF files a valid application for an extension of time to file its tax return.

(iii) Each QOF is permitted only one correction for a trade or business pursuant to this paragraph (d)(6). If the entity, at the end of the additional six-month cure period, fails to qualify as a qualified opportunity zone business, then the QOF becomes subject to the penalty under section 1400Z–2(f)(1) for each month the entity failed to qualify as a qualified opportunity zone business beginning with the first month following the last month that the QOF met the *90-percent investment standard*.

(e) *Applicability dates*—(1) *In general*. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2) *Prior periods*. With respect to the portion of a taxpayer's first taxable year ending after December 21, 2017, and for taxable years beginning after December 21, 2017, and on or before March 13, 2020, a taxpayer may choose either—

(i) To apply the section 1400Z–2 regulations, if applied in a consistent manner for all such taxable years (reliance by a taxpayer on paragraph (e)(2)(ii) of this section, §1.1400Z2(a)–1(g)(2)(ii), §1.1400Z2(b)–1(j)(2)(ii), §1.1400Z2(d)–2(e)(2)(ii), or §1.1400Z2(f)–1(d)(2)(ii), is disregarded solely for purposes of the consistency requirement under this paragraph (e)(2)(i)); or

(ii) To rely on the rules in proposed §1.1400Z2(d)–1 contained in the notice of proposed rulemaking (REG–115420–

18) published on October 29, 2018, as amplified by the notice of proposed rulemaking (REG–120186–18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

[T.D. 9889, 85 FR 1977, Jan. 13, 2020; 85 FR 19083, April 6, 2020]

EDITORIAL NOTE: At 85 FR 19083, April 6, 2020, § 1.1400Z2(d)–1 was amended in part by redesignating paragraphs (d)(3)(ix) and (x) as (d)(3)(viii) and (ix); however, the amendment could not be incorporated due to inaccurate amendatory instruction.

§ 1.1400Z2(d)–2 Qualified opportunity zone business property.

(a) *Qualified opportunity zone business property*—(1) *In general*. This section provides rules for determining whether owned or leased tangible property held by an eligible entity (within the meaning of § 1.1400Z2(d)–1(a)(1)) is qualified opportunity zone business property within the meaning of section 1400Z–2(d)(2)(D). Paragraph (a)(2) of this section provides general requirements that tangible property must satisfy to be qualified opportunity zone business property. Paragraph (b) of this section provides rules related to owned tangible property. Paragraph (c) of this section provides rules related to leased tangible property (that is, tangible property that the eligible entity acquires by lease from a lessor). Paragraph (d) of this section provides rules related to the 90-percent qualified opportunity zone business property holding period requirement and the 70-percent use test of section 1400Z–2(d)(2)(D)(i)(III). Paragraph (e) of this section provides the dates of applicability of this section.

(2) *Qualified opportunity zone business property requirements*. The term *qualified opportunity zone business property* means tangible property owned or leased by an eligible entity (as defined in § 1.1400Z2(d)–1(a)(1)) that—

(i) Is used by the eligible entity in a trade or business within the meaning of section 162; and

(ii) Satisfies the requirements of paragraphs (b), (c), and (d) of this section, as applicable.

(b) *Tangible property owned by an eligible entity*—(1) *Purchase requirement*—(i) *In general*. In the case of tangible property that is owned by an eligible entity, the tangible property must be acquired by the eligible entity after December 31, 2017, by purchase as defined by section 179(d)(2) from a person that is not a related person within the meaning of section 1400Z–2(e)(2) (providing that persons are related to each other if such persons are described in section 267(b) or section 707(b)(1), determined by substituting ''20 percent'' for ''50 percent'' each place it appears in such sections).

(ii) *Plan, intent, or expectation for seller to repurchase acquired property*. In the case of real property that is purchased by an eligible entity, if, at the time of the purchase, there was a plan, intent, or expectation for the acquired real property to be repurchased by the seller of the real property for an amount of consideration other than the fair market value of the real property, determined at the time of the repurchase by the seller, the purchased real property is not qualified opportunity zone business property.

(iii) *Property manufactured, constructed, or produced for use in a qualified opportunity zone*—(A) *In general*. In the case of tangible property manufactured, constructed, or produced by an eligible entity, if the property is manufactured, constructed, or produced for use by an eligible entity with the intent to use such property in a trade or business in a qualified opportunity zone, then such property satisfies the requirements of paragraph (b)(1)(i) of this section if the manufacture, construction, or production begins after December 31, 2017. The materials and supplies used to manufacture, construct, or produce qualified opportunity zone business property by the eligible entity must also be qualified opportunity zone business property.

(B) *Time when manufacture, construction or production considered to begin*. For purposes of paragraph (b)(1)(iii) of this section, the acquisition date of such property is the date on which the manufacture, construction, or production of property (as defined in paragraph (b)(1)(iii) of this section) begins. The manufacture, construction, or production of property begins when physical work of a significant nature begins. Physical work does not include

preliminary activities such as planning or designing, securing financing, exploring or researching. The determination of when physical work of a significant nature begins depends on the facts and circumstances. For example, if a factory is to be constructed on-site, construction begins when physical work of a significant nature commences at the site; this could occur, for example, when work begins on the excavation of footings, or the pourings of pads for the factory. Preliminary work, such as clearing or testing of soil condition, does not constitute the beginning of construction.

(C) *Safe harbor*. For purposes of paragraph (b)(1)(iii)(B) of this section, a taxpayer may choose to determine when physical work of a significant nature begins in accordance with this paragraph (b)(1)(iii)(C). Physical work of a significant nature will not be considered to begin before the taxpayer incurs or pays more than 10 percent of the total cost of the property (excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching).

(2) *Original use or substantial improvement requirement*—(i) *In general*. In the case of tangible property owned by the eligible entity either—

(A) The original use of the owned tangible property in the qualified opportunity zone, within the meaning of paragraph (b)(3) of this section, must commence with the eligible entity; or

(B) The eligible entity must substantially improve the owned tangible property within the meaning of paragraph (b)(4) of this section (which defines substantial improvement in this context).

(ii) *Inventory*. Inventory (including raw materials) of a trade or business produced by an eligible entity after December 31, 2017, is deemed to satisfy the requirements set forth in paragraphs (b)(1) and (b)(2)(i) of this section.

(3) *Original use of tangible property acquired by purchase*—(i) *Original use*—(A) *In general*. For purposes of paragraph (b)(2) of this section, the original use of tangible property in a qualified opportunity zone commences on the date any person first places the property in service in the qualified opportunity zone for purposes of depreciation or amortization, or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner.

(B) *Commencement of original use of vacant property*. For purposes of this paragraph (b)(3), if real property, including land and buildings, has been vacant for an uninterrupted period of at least one calendar year beginning on a date prior to the date on which the qualified opportunity zone in which the property is located is listed as a designated qualified opportunity zone in a QOZ designation notice and the property has remained vacant through the date on which the property was purchased by the eligible entity, or if the property has been vacant for an uninterrupted three calendar year period beginning on a date after the date of publication of the QOZ designation notice that lists as designated the qualified opportunity zone in which the property is located and the property has remained vacant through the date on which the property was purchased by the eligible entity, original use in the qualified opportunity zone commences on the date after that period when any person first so uses or places the property in service in the qualified opportunity zone. Such property must satisfy the definition of vacancy under paragraph (b)(3)(iii) of this section.

(C) *Used tangible property*. Used tangible property satisfies the original use requirement if the property has not been previously so used or placed in service in the qualified opportunity zone. If the tangible property had been so used or placed in service in the qualified opportunity zone before it is acquired by purchase, it must be substantially improved in order to satisfy the requirements of section 1400Z–2(d)(2)(D)(i)(II).

(D) *Example*. The following example illustrates the principles of paragraph (b)(3)(i)(A) of this section.

(*1*) *Facts*. On January 1, 2019, QOF A purchases from a developer a newly constructed hotel building located in a qualified opportunity zone for $10 million. The developer purchased a parcel of land in that qualified opportunity

zone, and constructed the hotel building thereon, with the intent and expectation to sell the building to a QOF. As of the time of the purchase, the developer had not placed the hotel building in service in the qualified opportunity zone for purposes of depreciation. Other than the original use requirement, assume that the hotel building satisfies all requirements under section 1400Z–2(d)(2)(D). In addition, assume that, at the time of the purchase, the developer had no plan, intent, or expectation to repurchase the hotel building.

(*2*) *Analysis*. At the time of QOF A's purchase of the hotel building, the original use of the hotel building had not commenced because the developer had not yet placed the hotel building into service for purposes of depreciation in a qualified opportunity zone. See paragraph (b)(3)(i)(A) of this section. Therefore, the original use of the hotel building in the qualified opportunity zone in which the building is located is treated as commencing with QOF A. See paragraph (b)(3)(i)(A) of this section. As a result, the hotel building purchased by QOF A is treated as satisfying the original use requirement of section 1400Z–2(d)(2)(D)(i)(II).

(ii) *Lessee improvements to leased property*. Improvements made by a lessee to leased property satisfy the original use requirement in section 1400Z–2(d)(2)(D)(i)(II) as purchased property for the amount of the unadjusted cost basis under section 1012 of such improvements.

(iii) *Vacancy*. Solely for purposes of meeting the requirements of section 1400Z–2, real property, including land and buildings, is considered to be in a state of vacancy if the property is significantly unused. A building or land will be considered significantly unused if more than 80 percent of the building or land, as measured by the square footage of useable space, is not currently being used.

(iv) *Brownfield sites*. An eligible entity that purchases a parcel of land that is a brownfield site, as defined by section 101 of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (42 U.S.C. 9601) (brownfield site), may treat all property composing the brownfield site (including the land and structures thereon) as satisfying the original use requirement of section 1400Z–2(d)(2)(D)(i)(II), if, within a reasonable period, the eligible entity makes investments in the brownfield site to ensure that all property composing the brownfield site meets basic safety standards for both human health and the environment.

(v) *Property involuntarily transferred to local government*. An eligible entity that purchases real property from a local government that the local government holds as the result of an involuntary transfer (including through abandonment, bankruptcy, foreclosure, or receivership) may treat all property composing the real property (including the land and structures thereon) as satisfying the original use requirement of section 1400Z–2(d)(2)(D)(i)(II).

(4) *Substantial improvement of tangible property acquired by purchase*—(i) *In general*. Except as provided in paragraph (b)(4)(iv) of this section, for purposes of paragraph (b)(2) of this section, tangible property is treated as substantially improved by an eligible entity only if it meets the requirements of section 1400Z–2(d)(2)(D)(ii) during the *30-month substantial improvement period*. The property has been substantially improved when the additions to basis of the property in the hands of the QOF exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the QOF (substantial improvement requirement).

(ii) *Treatment of property in the 30-month substantial improvement period*. For purposes of the *90-percent investment standard* under section 1400Z–2(d)(1), tangible property purchased, leased, or improved by a trade or business that is undergoing the substantial improvement process but has not yet been placed in service by the eligible entity or used in the eligible entity's trade or business is treated as satisfying the requirements of section 1400Z–2(d)(2)(D)(i) and paragraph (b)(2) of this section for the *30-month substantial improvement period* with respect to that property provided the eligible entity reasonably expects that the property will be substantially improved as defined in paragraph (b)(4)(i) of this section and used in the eligible entity's

trade or business in a qualified opportunity zone by the end of such 30-month period. Tangible property described in the preceding sentence is not considered qualified opportunity zone business property for purposes of the special rule in section 1400Z–2(d)(3)(B) unless the tangible property is qualified opportunity zone business property for at least two years without regard to this paragraph (b)(4)(ii).

(iii) *Aggregation of original use property that improves the functionality of non-original use property*—(A) *General rule*. The cost of purchased property that would otherwise qualify as qualified opportunity zone business property may be taken into account in determining whether additions to the basis of non-original use property acquired by purchase satisfy the substantial improvement requirement under section 1400Z–2(d)(2)(D)(ii), so long as the purchased property is located in the same qualified opportunity zone (or a contiguous qualified opportunity zone) as the non-original use property, is used in the same trade or business as the non-original use property, and improves the functionality of the non-original use property.

(B) *Improvement of non-original use real property*. If an eligible entity chooses to apply this paragraph (b)(4)(iii) to non-original use real property, the eligible entity must improve the non-original use real property by more than an insubstantial amount within the meaning of paragraph (b)(4)(iv)(C) of this section.

(C) *Effect on purchased property*. If an eligible entity chooses to apply this paragraph (b)(4)(iii), the purchased property that would otherwise qualify as qualified opportunity zone business property will not be treated as original use property, and instead the basis of that purchased property will be taken into account in determining whether additions to the basis of the non-original use property satisfy the requirements under section 1400Z–2(d)(2)(D)(i)(II) and (d)(2)(D)(ii).

(D) *Examples*. The following examples illustrate the principles of paragraph (b)(4)(iii) of this section.

(*1*) *Example 1*—(*i*) *Facts*. On January 1, 2019, QOF A purchases the assets of a hotel business located in a qualified opportunity zone for $5 million. The purchased assets include land, a building, linens, furniture and other fixtures attached to the building. $1 million of the purchase price is allocated to land and the remaining $4 million is allocated to the building, furniture and fixtures. During the course of renovations over the 30-month substantial improvement period, the QOF spent $1 million replacing linens, mattresses and furniture, $500,000 on the purchase of new exercise equipment for a gym located in the hotel building, $1 million on renovations for a restaurant (including restaurant equipment) attached to the hotel, and $1.5 million on structural renovations to the hotel. The QOF chooses to apply paragraph (b)(4)(iii) of this section to determine whether the substantial improvement requirement in section 1400Z–2(d)(2)(D)(ii) is met.

(*ii*) *Analysis*. In order for the hotel to be considered qualified opportunity zone business property, QOF A must substantially improve the hotel as the hotel had previously been placed in service in the qualified opportunity zone. (QOF A was not required to substantially improve the land on which the hotel was located pursuant to paragraph (b)(4)(iv) of this section.) Because the amount of basis allocated to the hotel was $4 million, QOF A must expend $4 million to improve the hotel within the 30-month substantial improvement period provided in section 1400Z–2(d)(2)(D)(ii). The new linens, mattresses and furniture, new exercise equipment, and new restaurant equipment all qualify as original use assets under section 1400Z–2(d)(2)(D)(i)(II). QOF A also substantially improved the hotel, which was the asset that needed to be improved under section 1400Z–2(d)(2)(D)(i)(II). QOF A chose, at the start of the 30-month period, to include the costs of the newly purchased assets that improve the functionality of the hotel to the basis of the hotel. Thus, the cost of these items is eligible to be added to the hotel's basis pursuant to paragraph (b)(4)(iii) of this section. Therefore, QOF A has met the substantial improvement requirement under section 1400Z–2(d)(2)(D)(i)(II) by doubling its basis in the hotel and its fixtures within the 30-month substantial improvement period. The amounts

spent replacing linens, mattresses, furniture, exercise equipment, and new restaurant equipment that were counted toward the substantial improvement requirement for the hotel are not considered original use assets for purposes of the *90-percent investment standard*.

(*2*) *Example 2*—(*i*) *Purchase of unrelated property*. The facts are the same as in paragraph (b)(4)(iii)(D)(*1*)(*i*) of this section, except that in addition to purchasing the hotel and the related land, QOF A also purchases an apartment building one block away from the hotel for $10 million. The apartment building is located in the same qualified opportunity zone as the hotel.

(*ii*) *Analysis*. QOF A may not include any improvements made to the apartment building, including purchased property that improves the functionality of the apartment building, to the basis of the hotel. QOF A may choose, under paragraph (b)(4)(iii) of this section, to include the purchased property that improves the functionality of the apartment building in the basis of the apartment building for purposes of the substantial improvement requirement under section 1400Z–2(d)(2)(D)(i)(II).

(iv) *Special rules for land and improvements on land*—(A) *Buildings located in a qualified opportunity zone*. In accordance with the rules set forth in this paragraph (b)(4)(iv)(A), if an eligible entity purchases a building located on a parcel of land within the geographic borders of a qualified opportunity zone, for purposes of section 1400Z–2(d)(2)(D)(ii), a substantial improvement to the building is measured by the eligible entity's additions to the basis of the building, as determined under section 1012.

(B) *Unimproved land*. Unimproved land that is within a qualified opportunity zone and acquired by purchase in accordance with section 1400Z–2(d)(2)(D)(i)(I) is not required to be substantially improved within the meaning of section 1400Z–2(d)(2)(D)(i)(II) and (d)(2)(D)(ii).

(C) *Exception for insubstantially improved land*. Notwithstanding paragraph (b)(4)(iv)(B) of this section, if the land is unimproved or minimally improved and the eligible entity purchases the land with an expectation or an intention to not improve the land by more than an insubstantial amount within 30 months after the date of purchase, paragraph (b)(4)(iv)(B) of this section does not apply with respect to such land and such land is not considered qualified opportunity zone business property unless it is substantially improved within the meaning of sections 1400Z–2(d)(2)(D)(i)(II) and (d)(2)(D)(ii). In determining whether an eligible entity had an expectation or an intention to improve the land by more than an insubstantial amount, improvements to the land by the eligible entity (including grading, clearing of the land, remediation of the contaminated land, or acquisition of related qualified opportunity zone business property that facilitates the use of the land in a trade or business of the eligible entity) will be taken into account.

(D) *Remediation of contaminated land*. Betterments to land within the meaning of § 1.263(a)–3(j)(1)(i) may be added to the basis of the purchased land and included for purposes of section 1400Z–2(d)(2)(D)(ii) if the betterments are paid for by the eligible entity.

(E) *Separate improvement to underlying land not required*. In determining whether the substantial improvement test under section 1400Z–2(d)(2)(D) has been met with respect to a building, there is no requirement that the eligible entity separately substantially improve the land upon which the building is located.

(v) *Aggregation of purchased buildings*—(A) *Substantial improvement requirement for eligible building group*. For purposes of applying the substantial improvement requirement under sections 1400Z–2(d)(2)(D)(i)(II) and 1400Z–2(d)(2)(D)(ii), an eligible entity may apply paragraph (b)(4)(v)(D) of this section with respect to two or more buildings located within a qualified opportunity zone or a single series of contiguous qualified opportunity zones, as described in paragraph (b)(4)(v)(B) or (C) of this section (eligible building group), respectively.

(B) *Eligible building group located entirely within parcel of land described in single deed*. All buildings comprising an eligible building group may be treated as a single property as that term is

used in section 1400Z–2(d)(2)(D)(ii) (single property), if each building comprising the eligible building group is located entirely within the geographic borders of a parcel of land described in a single deed.

(C) *Eligible building group spanning contiguous parcels of land described in separate deeds.* An eligible entity may treat all buildings comprising an eligible building group located entirely within the geographic borders of contiguous parcels of land described in separate deeds as a single property to the extent each building is operated as part of one or more trades or businesses that—

(*1*) Are operated exclusively by the eligible entity;

(*2*) Share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; and

(*3*) Are operated in coordination with, or reliance upon, one or more of the trades or businesses (for example, supply chain interdependencies or mixed-use facilities).

(D) *Calculation of aggregate building basis and additions to basis of single property—*(*1*) *In general.* For purposes of the substantial improvement requirement under section 1400Z–2(d)(2)(D)(ii), the amount of basis required to be added to the portion of an eligible building group treated as a single property equals the total amount of basis calculated by adding the basis of each building comprising the single property at the beginning of the 30-month period and additions to the basis of each building comprising the single property are aggregated to determine satisfaction of the substantial improvement requirement.

(*2*) *Aggregation of original use property that improves the functionality of single property.* In applying paragraph (b)(4)(v)(D)(*1*) of this section, purchased property that would otherwise qualify as qualified opportunity zone business property may be taken into account in determining whether additions to the basis of a single property described in paragraph (b)(4)(v)(B) or (C) of this section satisfy the substantial improvement requirement under section 1400Z–2(d)(2)(D)(ii).

(c) *Tangible property leased by an eligible entity.* In the case of tangible property with respect to which an eligible entity is a lessee—

(1) *Qualifying acquisition of possession.* The tangible property must be acquired by the eligible entity under a lease entered into after December 31, 2017.

(2) *Arms-length terms*—(i) *General rule.* The terms of the lease must be market rate (that is, the terms of the lease reflect common, arms-length market pricing in the locale that includes the qualified opportunity zone as determined under section 482 and all section 482 regulations in this chapter) at the time that the lease was entered into.

(ii) *Rebuttable presumption regarding unrelated persons.* There will be a rebuttable presumption that the terms of the lease were market rate for leases between persons not related within the meaning of section 1400Z–2(e)(2) (unrelated persons), and thus, the parties to the lease are not required to perform a section 482 analysis.

(iii) *Exception for state, local, and Indian tribal governments.* For purposes of this paragraph (c)(2), tangible property acquired by lease from a state or local government, or an Indian tribal government, is not considered tangible property acquired by lease from a related person within the meaning of section 1400Z–2(e)(2) (related person).

(3) *Additional requirements for tangible property leased from a related person.* If the lessor is a related person with respect to an eligible entity that is the lessee of tangible property, the requirements of paragraphs (c)(3)(i) and (ii) of this section, as applicable, must be satisfied in order for the tangible property to be treated as qualified opportunity zone business property.

(i) *Prepayments of not more than one year.* The lessee at no time makes any prepayment in connection with the lease relating to a period of use of the tangible property that exceeds 12 months.

(ii) *Purchase of other qualified opportunity zone business property.* In the case of leased tangible property that is personal property, if the original use of the leased tangible personal property in a qualified opportunity zone (within

the meaning of paragraph (c)(3)(iii) of this section) does not commence with the lessee, the property is not qualified opportunity zone business property unless, during the relevant testing period (as defined in paragraph (c)(3)(iv) of this section), the lessee becomes the owner of tangible property that is qualified opportunity zone business property having a value not less than the value of that leased tangible personal property. There must be substantial overlap of the qualified opportunity zone(s) in which the owner of the tangible property so acquired uses it and the qualified opportunity zone(s) in which that person uses the leased tangible personal property.

(iii) *Original use of leased tangible property*—(A) *In general.* For purposes of paragraph (c)(3)(ii) of this section, the original use of leased tangible property in a qualified opportunity zone commences on the date any person first places the property in service in the qualified opportunity zone for purposes of depreciation (or first uses the property in the qualified opportunity zone in a manner that would allow depreciation or amortization if that person were the property's owner).

(B) *Used leased tangible property.* Used leased tangible personal property can satisfy the original use requirement if the property has not been previously so used or placed in service in the qualified opportunity zone.

(iv) *Relevant testing period.* For purposes of paragraph (c)(3)(ii) of this section, the *relevant testing period* is the period that begins on the date that the lessee receives possession under the lease of the leased tangible personal property and ends on the earlier of—

(A) The date 30-months after the date the lessee receives possession of the leased tangible personal property under the lease; or

(B) The last day of the term of the lease (within the meaning of § 1.1400Z2(d)–1(b)(4)(iii)(D)).

(4) *Plan, intent, or expectation for purchases not for fair market value.* In the case of real property that is leased by an eligible entity, if, at the time the lease is entered into, there was a plan, intent, or expectation for the real property to be purchased by the eligible entity for an amount of consideration other than the fair market value of the real property determined at the time of the purchase without regard to any prior lease payments, the leased real property is not qualified opportunity zone business property.

(d) *Holding period and use within a qualified opportunity zone of owned or leased tangible property*—(1) *In general.* In the case of tangible property that is owned or leased by an eligible entity, during substantially all of the eligible entity's holding period for the tangible property, substantially all of the use of the tangible property must be in a qualified opportunity zone.

(2) *Valuation of owned and leased property.* For purposes of the 70-percent use test in paragraph (d)(4) of this section, the value of owned and leased property is required to be determined in accordance with the valuation methodologies provided in § 1.1400Z2(d)–1(b), and such value in the case of leased tangible personal property is to be determined on the date the lessee receives possession of the tangible personal property under the lease.

(3) *Substantially all of an eligible entity's holding period for owned or leased tangible property*—(i) *In general.* For purposes of determining whether the holding period requirement in paragraph (d)(1) of this section is satisfied, the term *substantially all* means at least 90 percent. The holding period requirement is applied on a semiannual basis, based on the entire amount of time the eligible entity has owned or leased such property. Thus, on each semiannual testing date of the eligible entity, the tangible property satisfies the 90-percent qualified opportunity zone business property holding period requirement of section 1400Z–2(d)(2)(D)(i)(III) only if, during at least 90 percent of the period during which the QOF has owned or leased the property, the property has satisfied the 70-percent use test in paragraph (d)(4) of this section.

(ii) *Semiannual qualified opportunity zone business test.* For purposes of determining satisfaction of the 90-percent qualified opportunity zone business property holding period test described in paragraph (d)(3)(i) of this section in the case of a QOF, the determination of

whether property satisfies the 70-percent use test is made on a semiannual basis pursuant to section 1400Z–2(d)(1) and paragraph (d)(4) of this section.

(4) *Substantially all of the use of owned or leased tangible property in a qualified opportunity zone*—(i) *Qualified tangible property*. Tangible property used in a trade or business of an eligible entity satisfies the *substantially all* requirement of paragraph (d)(1) of this section if and only if the tangible property is qualified tangible property. Qualified tangible property is tangible property that satisfies the requirements of paragraph (d)(4)(ii), (iii) (subject to the limitation in paragraph (d)(4)(iv) of this section), or (v) of this section.

(ii) *70-percent use test*. Tangible property held by a trade or business is qualified tangible property to the extent, based on the number of days between two consecutive semiannual testing dates, not less than 70 percent of the total utilization of the tangible property by the trade or business occurs at a location within the geographic borders of a qualified opportunity zone (that is, the 70-percent use test).

(iii) *Safe harbor for tangible property utilized in rendering services inside and outside of a qualified opportunity zone*. Subject to the limitation described in paragraph (d)(4)(iv) of this section, tangible property utilized by a trade or business in rendering services both inside and outside of the geographic borders of a qualified opportunity zone may be treated as qualified tangible property if—

(A) The tangible property utilized in rendering the service directly generates gross income for the trade or business both inside and outside of the geographic borders of a qualified opportunity zone;

(B) The trade or business has an office or other facility located within the geographic borders of a qualified opportunity zone (QOZ office);

(C) The tangible property is operated by employees of the trade or business who—

(*1*) Regularly use a QOZ office of the trade or business in the course of carrying out their duties; and

(*2*) Are managed directly, actively, and substantially on a day-to-day basis by one or more employees of the trade or business who carry out their duties at a QOZ office; and

(D) The tangible property is not operated exclusively outside of the geographic borders of a qualified opportunity zone for a period longer than 14 consecutive days for the generation of gross income for the trade or business.

(iv) *Limitation*. For purposes of the *70-percent tangible property standard*, the safe harbor provided in paragraph (d)(4)(iii) of this section may not be used to treat more than 20 percent of the tangible property of the trade or business as qualified tangible property.

(v) *Safe harbor for tangible property owned by leasing businesses with QOZ offices*. Tangible property of a trade or business, the employees of which use a QOZ office of the trade or business to regularly lease such tangible property to customers of the trade or business, may be treated as qualified tangible property if—

(A) Consistent with the normal, usual, or customary conduct of the trade or business, when not subject to a lease to a customer of the trade or business, the tangible property is parked or otherwise stored at a QOZ office; and

(B) No lease under which a customer of the trade or business acquires possession of the tangible property is for a duration (including extensions) longer than 30 consecutive days.

(vi) *Use of tangible property in one or more qualified opportunity zones*. In accordance with paragraphs (d)(4)(ii) through (v) of this section, if qualified tangible property is utilized by the trade or business in one or more qualified opportunity zones, satisfaction of the 70-percent use test is determined by aggregating the number of days the tangible property is utilized by the trade or business in each qualified opportunity zone.

(vii) *Real property straddling a qualified opportunity zone*. For purposes of satisfying the requirements in this paragraph (d), the rules of § 1.1400Z2(d)–1(d)(3)(ix) apply to a QOF or qualified opportunity zone business for determining whether real property is situated in a qualified opportunity zone.

(viii) *Safe harbor for inventory in transit*—(A) *In general*. In determining

whether tangible property is used in a qualified opportunity zone for purposes of applying the 70-percent use test under paragraph (d)(4) of this section, inventory (including raw materials) of a trade or business does not fail to be used in a qualified opportunity zone solely because the inventory is in transit—

(*1*) From a vendor to a facility of the trade or business that is in a qualified opportunity zone; or

(*2*) From a facility of the trade or business that is in a qualified opportunity zone to customers of the trade or business that are not located in a qualified opportunity zone.

(B) *No effect from certain events in transit*. The distance traveled by the inventory while it is in transit, or the fact that the inventory is briefly warehoused while in transit, does not affect the application of the safe harbor described in paragraph (d)(4)(viii) of this section.

(e) *Applicability dates*—(1) *In general*. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2) *Prior periods*. With respect to the portion of a taxpayer's first taxable year ending after December 21, 2017, and for taxable years beginning after December 21, 2017, and on or before March 13, 2020, a taxpayer may choose either—

(i) To apply the section 1400Z–2 regulations, if applied in a consistent manner for all such taxable years (reliance by a taxpayer on paragraph (e)(2)(ii) of this section, §1.1400Z2(a)–1(g)(2)(ii), §1.1400Z2(b)–1(j)(2)(ii), §1.1400Z2(d)–1(e)(2)(ii), or §1.1400Z2(f)–1(d)(2)(ii), is disregarded solely for purposes of the consistency requirement under this paragraph (e)(2)(i)); or

(ii) To rely on the rules in proposed §1.1400Z2(d)–1 contained in the notice of proposed rulemaking (REG–115420–18) published on October 29, 2018, as amplified by the notice of proposed rulemaking (REG–120186–18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

[T.D. 9889, 85 FR 1986, Jan. 13, 2020, 85 FR 19085, Apr. 6, 2020]

§ 1.1400Z2(e)–1 [Reserved]

§ 1.1400Z2(f)–1 Administrative rules-penalties, anti-abuse, etc.

(a) *In general*. Except as provided by §1.1400Z2(d)–1(a)(2)(iv)(B) with respect to a taxpayer's first taxable year as a QOF, if a QOF fails to satisfy the 90-percent investment standard in section 1400Z–2(d)(1), then the QOF must pay the statutory penalty set forth in section 1400Z–2(f) for each month it fails to meet the 90-percent investment standard.

(b) *Time period for a QOF to reinvest certain proceeds*—(1) *In general*. If a QOF receives proceeds from the return of capital or the sale or disposition of some or all of its qualified opportunity zone property within the meaning of section 1400Z–2(d)(2)(A), and if the QOF reinvests some or all of the proceeds in qualified opportunity zone property by the last day of the 12-month period beginning on the date of the distribution, sale, or disposition, then the proceeds, to the extent that they are so reinvested, are treated as qualified opportunity zone property for purposes of the 90-percent investment standard in section 1400Z–2(d)(1), but only to the extent that prior to the reinvestment in qualified opportunity zone property the proceeds are continuously held in cash, cash equivalents, or debt instruments with a term of 18 months or less. If reinvestment of the proceeds is delayed by waiting for governmental action the application for which is complete, that delay does not cause a failure of the 12-month requirement in this paragraph (b).

(2) *Federally declared disasters*. If the QOF's plan to reinvest some or all of the proceeds described in paragraph (b)(1) of this section in qualified opportunity zone property is delayed due to a federally declared disaster (as defined in section 165(i)(5)(A)), the QOF may receive not more than an additional 12 months to reinvest such proceeds, provided that the QOF invests such proceeds in the manner originally intended before the disaster.

(c) *Anti-abuse rules*—(1) *General anti-abuse rule*. Pursuant to section 1400Z–2(e)(4)(C), the rules of section 1400Z–2 and §§1.1400Z2(a)–1 through 1.1400Z2(d)–(2), 1.1400Z2(f)–1, 1.1502–14Z, and 1.1504–3

must be applied in a manner consistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations (as defined in §1.1400Z2(a)–1(b)(41)). The purposes of section 1400Z–2 and the section 1400Z–2 regulations are to provide specified Federal income tax benefits to owners of QOFs to encourage the making of longer-term investments, through QOFs and qualified opportunity zone businesses, of new capital in one or more qualified opportunity zones and to increase the economic growth of such qualified opportunity zones. Accordingly, if a significant purpose of a transaction is to achieve a Federal income tax result that is inconsistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations, a transaction (or series of transactions) will be recast or recharacterized for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations. This recasting and recharacterization may include, as appropriate, treating an investment as other than a qualifying investment. A determination of whether a Federal income tax result is inconsistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations must be based on all facts and circumstances.

(2) *Special anti-abuse rule for partnerships*—(i) *In general*. In addition to being subject to the general anti-abuse rule of paragraph (c)(1) of this section, the application of the rules of section 1400Z–2 and §§1.1400Z2(a)–1 through 1.1400Z2(d)–2, 1.1400Z2(f)–1, 1.1502–14Z, and 1.1504–3 to partnerships is also subject to the special anti-abuse rule set forth in paragraph (c)(2)(ii) of this section.

(ii) *Special partnership anti-abuse rule*. If a partnership is formed or availed of with a significant purpose of avoiding the requirements of §1.1400Z2(a)–1(b)(11)(i)(B) that a gain be subject to Federal income tax in order to be an eligible gain, the partnership will be disregarded in whole or in part for purposes of §1.1400Z2(a)–1(b)(11)(i)(B) and (b)(11)(ix)(B) to prevent the creation of a qualifying investment by the partnership with respect to any partner or partners that would not otherwise satisfy such requirements.

(3) *Examples*. The following examples illustrate the anti-abuse rule of paragraph (c) of this section.

(i) *Example 1*—(A) *Facts*. Two nonresident alien individuals (collectively, the individuals) plan to sell stock at a gain of $50, to invest the amount of the resulting capital gain in a QOF, and to make a deferral election under section 1400Z–2(a). They make this election with the intent of holding the QOF investment for 10 years and then making an election to increase the qualifying basis to fair market value under section 1400Z–2(c). A gain on a sale of the stock by the individuals, however, would not be subject to Federal income tax, and so the gain would not support their making a deferral election as a result of the requirement in §1.1400Z2(a)–1(b)(11)(i)(B). Instead of selling the stock themselves, the individuals form a domestic partnership with a significant purpose of using that partnership to make a deferral election with respect to the stock under the exception in §1.1400Z2(a)–1(b)(11)(ix)(B). The individuals contribute their stock to the partnership in exchange for partnership interests, after which the partnership sells the stock and invests the $50 gain in a QOF. Had the partnership not made a deferral election, the individuals would not be subject to tax on their allocated portion of the partnership's recognized gain on the sale of the stock.

(B) *Analysis*. Based on these facts, the partnership is formed and availed of with a significant purpose to avoid the requirements of §1.1400Z2(a)–1(b)(11)(i)(B). Thus, under paragraph (c)(2) of this section, the partnership is disregarded for purposes of applying §1.1400Z2(a)–1(b)(11)(ix)(B) to the $50 gain, and therefore the partnership's investment in the QOF is not a qualifying investment.

(ii) *Example 2*—(A) *Facts*. The facts are the same as in paragraph (c)(3)(i)(A) of this section (*Example 1*), except the individuals contribute their stock to an existing partnership, the sole partners of which are U.S. citizens, with a significant purpose of the individuals' use of the partnership being to make an investment in a QOF and a deferral election under the §1.1400Z2(a)–

1(b)(11)(ix)(B) exception for partnerships. During the year, the partnership sells property it owned before the individuals' contribution, resulting in capital gain of $100, all of which is eligible to be invested in a QOF. It also sells the stock contributed by the individuals, resulting in $50 of capital gain. The partnership invests $150 in a QOF and makes the requisite gain deferral election.

(B) *Analysis*. Based on these facts, the partnership is availed of by the individuals with a significant purpose to avoid the requirements of §1.1400Z2(a)–1(b)(11)(i)(B). Thus, under paragraph (c)(2) of this section, the partnership is disregarded for purposes of applying §1.1400Z2(a)–1(b)(11)(i)(B) and (b)(11)(ix)(B) with respect to the $50 capital gain from the sale of the individuals' contributed stock and that gain fails to be eligible gain. Under §1.1400Z2(a)–1(b), no section 1400Z–2(a) election is available for that gain and the partnership will have a mixed-funds investment, $100 of which is a qualifying investment and $50 of which is a non-qualifying investment.

(iii) *Example 3*—(A) *Facts*. Entity C is a QOF that meets the requirements of section 1400Z–2(d)(1). Entity C owns qualified opportunity zone stock in a domestic corporation described in section 1400Z–2(d)(2)(B) (Corporation C), which operates a qualified opportunity zone business. Entity C also owns Corporation D stock, which is not qualified opportunity zone stock, which stock is less than 10% of the assets of Entity C. Under section 1400Z–2(e)(2), these stock holdings cause Entity C to be related to both Corporation C and Corporation D. On date 1, under section 1400Z–2(e)(2), Individual S is not a related person with respect to Entity C, Corporation C, or Corporation D. On that date, Individual S sells tangible property to Corporation C (Asset 1) for use in Corporation C's qualified opportunity zone business and sells a second asset to Corporation D (Asset 2). Both items sold were capital assets (as defined in section 1221), and had an adjusted basis of $0. As a result, Individual S realizes gain of $100 from the sale to Corporation C and $75 from the sale to Corporation D. At the time of the sale Individual S has a plan or intent to invest $175 in Entity C and to make deferral elections under section 1400Z–2(a)(1) with respect to the gain from the two sales. On date 2, for $175 Individual S acquired an eligible interest in Entity C, an acquisition that causes Individual S to become a related person with respect to Entity C within the meaning of section 1400Z–2(e)(2). *Analysis*. Under paragraph (c)(1) of this section, Individual S's $175 gain is not an eligible gain and cannot be the subject a deferral election under section 1400Z–2(a)(1). The gain fails to satisfy §1.1400Z2a–1(b)(11)(i)(C) because of Individual S's plan to acquire sufficient equity in Entity C to become related to Corporations C and D. Moreover, for the same reason, the tangible property that Corporation C purchased from Individual S fails to satisfy the requirement that a purchase of qualified opportunity zone business property must be from an unrelated person. *See* sections 1400Z–2(d)(2)(D)(i)(I) and 179(d)(2)(A).

(B) *Circular movement of consideration*. The facts are the same as in paragraph (c)(3)(iii)(A) of this section (this Example 3), except that Entity C contributes the $100 and $75 (received from Individual S) to Corporations C and D, respectively, as part of a plan that includes each transaction described in paragraph (c)(3)(iii)(A) (collectively, the transaction series). Under the step transaction doctrine and circular cash flow principles, this circular movement of consideration is disregarded for Federal income tax purposes, including for purposes of section 1400Z–2 and the section 1400Z–2 regulations. Therefore, the transaction series is treated for Federal income tax purposes as a contribution by Individual S of Assets 1 and 2 to Entity C in exchange for an eligible interest in Entity C, followed by a contribution by Entity C of Assets 1 and 2 to Corporations C and D, respectively. This result also would obtain if Individual S were not related to Entity C immediately following Individual S's acquisition of its eligible interest from Entity C. *See* Rev. Rul. 83–142, 1983–2 C.B. 68; Rev. Rul. 78–397, 1978–2 C.B. 150.

(iv) *Example 4*—(A) *Facts*. Entity D is a QOF that meets the requirements of section 1400Z–2(d)(1). Entity D owns a majority qualified opportunity zone

partnership interest in a domestic partnership, Partnership D described in section 1400Z–2(d)(2)(C). Entity D organized Partnership D for the purpose of being a qualified opportunity zone business. Partnership D acquires a tract of land located in a qualified opportunity zone. At the time of the acquisition of that land, there was no plan or intent to develop or otherwise utilize the land in a trade or business that would increase substantially the economic productivity of the land. Instead, there was a plan to pave the land for use as a parking lot. Partnership D planned to install a gate to the paved parking area, a small structure that would serve as an office for a parking attendant, and two self-pay stations for use by customers. The parking lot was not reasonably expected to expand significantly, and the initial small number of employees was not reasonably expected significantly to increase. A significant purpose for the acquisition of the land was to sell the land at a profit and to exclude any gain from appreciation by making an election under section 1400Z–2(c).

(B) *Analysis*. Under paragraph (c)(1) of this section, the acquisition of the land is a transaction carried out to achieve a tax result that is inconsistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations. Consequently, the land is not qualified opportunity zone business property and gain from the sale of the land will not be eligible to be excluded from gross income under section 1400Z–2(c). This recharacterization of the qualification of the land for Federal tax purposes is appropriate to ensure that the tax results of the transaction, including the status of Partnership D as a qualified opportunity zone business, are consistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations. Partnership D fails to be a qualified opportunity zone business unless other assets that it owns or leases are qualified opportunity zone business property that satisfy section 1400Z–2(d)(3)(A)(i), and the other requirements of section 1400Z–2 and the section 1400Z–2 regulations.

(v) *Example 5*—(A) *Facts*. The facts are the same as in paragraph (c)(3)(iv) of this section, except that Partnership D, in year 1, acquired a tract of land located in a qualified opportunity zone that was previously used for hog and pig farming. On its Form 1065T the previous owner, also a partnership, properly described those activities with the principal business activity code 112210. During the several-year period ending on the date of the acquisition of the land, the value of the land had significantly increased and D projected the land to continue to increase in value by ten-fold during the following 10-year period. At the time of the acquisition, Partnership D intended to conduct sheep and goat farming activities on the land and, accordingly, planned to use principal business activity code 112400 on its Form 1065. According to its plan, Partnership D conducted sheep and goat farming activities on the land during the 10-year period beginning on the date of acquisition of the land. During the 10-year period, Partnership D made significant capital improvements to the land, including improvements to existing farm structures, construction of new farm structures, and installation of a new irrigation system. As expected, the value of the land substantially increased during the following decade. The owners' entire interest in Partnership D was a qualifying investment, and, after having held it for at least 10 years the owners sold the entire interest at a large gain. As planned the owners made an election under section 1400Z–2(c) in order to avoid tax on the gain from the sale.

(B) *Analysis*. The modification of the land to suit sheep and goat farming activity from its previous use of hog and pig farming, and the significant capital improvements made to land, comprise a significant investment in the business activities on the land. Thus, Partnership D did not hold the land solely for speculative investment. As a result, under paragraph (c)(1) of this section, the acquisition of the land, the activities conducted on the land, the capital improvements made to the land, and the later disposition of the land for a significant profit are not inconsistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations.

(vi) *Example 6*—(A) *Facts*. Individuals intend to sell stock at a capital gain

and invest the resulting gain in a QOF pursuant to a deferral election under section 1400Z–2(a). The individuals form Entity F and file Form 8996 certifying that Entity F is a QOF organized for the purpose of investing in qualified opportunity zone property. Individuals have no intention of investing in qualified opportunity zone property. Instead individuals intend to invest in property other than qualified opportunity zone property hoping that the property will appreciate substantially in value and the individuals will be able to exclude any appreciation on their investment from gross income by making an election under section 1400Z–2(c). Each year Entity F files Form 8996 and pays the applicable penalty under section 1400Z–2(f). After holding their interests in Entity F for 10 years, individuals sell their interest in Entity F to an unrelated third party for a substantial gain and make an election to exclude the appreciation on their investment under section 1400Z–2(c).

(B) *Analysis*. A significant purpose of the transaction is to achieve a tax result that is inconsistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations, and the transaction will be recast and recharacterized for Federal tax purposes so that Entity F is not a QOF and the individuals are not eligible for the elections under sections 1400Z–2(a) and (c).

(vii) *Example 7*—(A) *Facts*. Entity E treats itself as a QOF that meets the requirements of section 1400Z–2(d)(1). Entity E owns all of the stock in a domestic corporation, Corporation E, and Entity E treats this stock as qualified opportunity zone stock. Corporation E uses the majority of the cash invested by Entity E to purchase gold bars from unrelated parties within the meaning of section 1400Z–2(e)(2). The aggregate value of the gold bars is $1000. Corporation E rents a safe deposit box in a qualified opportunity zone and hires one employee to manage the purchase and sale of the gold bars. Each year Corporation E purchases a small number of additional gold bars and sells to customers a portion of the gold bars on hand. The aggregate value of both the purchases and sales approximates half the value of the bars held at the beginning of the year. Corporation E seeks to treat the gold bars as qualified opportunity zone business property within the meaning of section 1400Z–2(d)(3). At the time that Corporation E began the gold bar business, it did not reasonably expect the business to expand significantly, nor was the number of employees reasonably expected to increase. Gold, however, was reasonably expected to appreciate. Ten years after the formation of Entity E, the investors in Entity E sell all of their interests in the entity and seek to make an election under section 1400Z–2(c) to exclude any gain from appreciation.

(B) *Analysis*. Under paragraph (c)(1) of this section, a significant purpose of Corporation E's activities is to achieve a tax result that is inconsistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations. The gold bar business carried out by Corporation E was merely speculative in nature and was not expected to increase economic activity in the subject qualified opportunity zone in a manner consistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations. As a result, Corporation E's activities are carried on to achieve tax results that are inconsistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations. Consequently, the gold bars are not qualified opportunity zone property. Corporation E fails to be a qualified opportunity zone business unless other assets that it owns or leases are qualified opportunity zone business property that satisfy section 1400Z–2(d)(3)(A)(i) (along with other requirements). If Corporation E fails to be a qualified opportunity zone business, Corporation E's stock fails to be qualified opportunity zone property in the hands of Entity E.

(d) *Applicability date*—(1) *In general*. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2) *Prior periods*. With respect to the portion of a taxpayer's first taxable year ending after December 21, 2017, that began on March 13, 2020, a taxpayer may choose either—

(i) To apply the section 1400Z–2 regulations, if applied in a consistent manner for all such taxable years (reliance by a taxpayer on paragraph (d)(2)(ii) of this section, §1.1400Z2(a)–1(g)(2)(ii),

§ 1.1400Z2(b)–1(j)(2)(ii), § 1.1400Z2(d)–1(e)(2)(ii), or § 1.1400Z2(d)–2(e)(2)(ii), is disregarded for purposes of the consistency requirement under this paragraph (d)(2)(i)); or

(ii) To rely on the rules in proposed § 1.1400Z2(f)–1 contained in the notice of proposed rulemaking (REG–115420–18) published on October 29, 2018, as amplified by the notice of proposed rulemaking (REG–120186–18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

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